APPENDIX

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UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

In re F5 NETWORKS, INC. DERIVATIVE LITIGATION.	Master File No. C06-794RSL ORDER CERTIFYING QUESTION TO THE WASHINGTON STATE SUPREME COURT

On May 20, 2008, the Court ordered the parties in this case to show cause why the Court should not certify a question asking the Washington State Supreme Court to provide the substantive standard establishing when demand is excused under RCW 23B.07.400(2) in a shareholder derivative action against a Washington corporation. See Dkt. #92 (Order to Show Cause). The individual defendants who responded to the order, and nominal defendant F5 Networks, Inc. ("F5"), do not oppose certification. See Dkt. ## 94, 95, 97. Plaintiffs assert in response that certification is unnecessary because: (1) the Washington State Supreme Court, if asked, would likely adopt Delaware's demand futility standard; and (2) the "case could be mooted by future events" given that F5 might appoint a special litigation committee that would "likely seek to terminate and/or otherwise resolve the pending action." See Dkt. #96 at 1, 4-5. Plaintiffs' primary objection, however, is delay. Id. at 5 ("[S]ignificant amounts of public and private resources can be conserved by deciding the pending motions to dismiss without certifying the proper pleading burden for futility of demand to the Washington Supreme

Court.").

The Court finds plaintiffs' arguments in response to the Order to Show Cause unavailing. First, as set forth in the Court's Order to Show Cause, the extent to which the Washington State Supreme Court follows Delaware law on the issue of demand futility is an open question. See Dkt. #92 at 3-7. Second, speculation by the plaintiffs that future actions might moot issues in this case does not affect the threshold, and potentially dispositive, issue of demand futility pending before the Court. See Dkt. #80 (F5's Motion To Dismiss Amended Complaint For Failure To Make Demand). Finally, while the certification process will cause some delay in this case, the procedure serves the two broader judicial interests of efficiency and comity: as noted by the United States Supreme Court, in the long run certification saves "time, energy and resources and helps build a cooperative judicial federalism." Lehman Bros. v. Schein, 416 U.S. 386, 391 (1974). And, for the reasons set forth in the Court's Order to Show Cause, the Court is of the opinion that certification is necessary under RCW 2.60.020 to ascertain, as a matter of first impression, Washington's substantive standard for establishing when demand is excused pursuant to RCW 23B.07.400(2) in a shareholder derivative action against a Washington corporation.

Therefore, the Court respectfully certifies the following question to the Washington State Supreme Court:

> "What test does Washington apply to determine whether allegations made pursuant to RCW 23B.07.400(2) by a shareholder seeking to initiate derivative litigation on behalf of a Washington corporation excuse that shareholder from first making demand on the board of directors to bring that litigation on behalf of the corporation?; and
>
> If Washington follows Delaware's demand futility standard, does it also follow the reasoning of Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007) in cases where the improper backdating of stock options has been alleged?"

The Court does not intend its framing of the question to restrict the Washington State Supreme Court's consideration of any issues that it determines are relevant. If the Washington

State Supreme Court decides to consider the certified question, it may in its discretion reformulate the question. See, e.g., Keystone Land & Dev. Co. v. Xerox Corp., 353 F.3d 1093, 1098 (9th Cir. 2003).

The Clerk of Court is directed to submit to the Washington State Supreme Court certified copies of this Order, a copy of the docket in the above-captioned matter, and Dkt. ## 1, 37, 39, 49, 50, 53, 54, 59, 60, 67, 69, 74, 80, 81, 84, 86, 87, 89, 90, 92, 94-97. The record so compiled contains all matters in the pending cause deemed material for consideration of the local law in question certified for answer. See RCW 2.60.010, 2.60.030.

The matter is hereby STAYED pending the Washington State Supreme Court's decision whether it will accept review, and if so, receipt of the certified answer to the certified question.

If the Washington State Supreme Court accepts review of the certified question, the Court designates F5 as the party to file the first brief under RAP 16.16(e)(1). The Clerk of Court shall notify the parties as soon as possible, but no more than three days, after the above-described record is filed with the Washington State Supreme Court. The parties are referred to RAP 16.16 and RCW 2.60.030 for additional information regarding the procedure before the Washington State Supreme Court.

DATED this 3rd day of July, 2008.

Robert S. Lasnik
United States District Judge

A:2

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

In re F5 NETWORKS, INC. DERIVATIVE LITIGATION.	Master File No. C06-794RSL ORDER TO SHOW CAUSE

I. INTRODUCTION

This matter comes before the Court on "Nominal Defendant F5 Networks, Inc.'s Motion to Dismiss Amended Complaint for Failure to Make Demand" (Dkt. #49). In its motion, nominal defendant F5 Networks, Inc. ("F5") requests dismissal of plaintiffs' derivative complaint because plaintiffs did not make a pre-litigation demand on F5's board of directors and plaintiffs have failed to plead particularized facts showing that demand was excused as futile. As set forth below, the Court orders the parties to show cause why the Court should not certify a question asking the Washington State Supreme Court to provide the substantive standard establishing when demand is excused under RCW 23B.07.400(2) in a shareholder derivative action against a Washington corporation.

II. DISCUSSION

A. Background

This action arises out of the recent publicity focused on companies that allegedly backdated stock options as a form of compensation to high-level executives. On May 16, 2006, the Center for Financial Research and Analysis ("CFRA") issued a report entitled "Options Backdating, Which Companies Are At Risk?" in which CFRA reviewed the option prices of 100 public companies and, based upon an analysis of the exercise prices of option grants with reference to the companies' stock prices, concluded that 17% of the subject companies, were in CFRA's view, "at risk for having backdated option grants during the period 1997 to 2002." See Dkt. #54, Ex. 1 (F5's Form 10-K/A filed with the SEC on December 12, 2006) at 20. F5 was one of the 17 companies so identified. Id.; see also James Bandler et al., Criminal Probe Of UnitedHealth's Options Begins, Wall St. J., May 18, 2006, at C1 ("An accounting-research firm this week identified 17 companies it termed as having 'the highest risk of having backdated options.'"). Shortly thereafter, F5 announced that it had received a grand jury subpoena from the Eastern District of New York and a notice of informal inquiry from the Securities and Exchange Commission ("SEC"). See Dkt. #54, Ex. 1 at 10. This set off a rush to the courthouse.

In 2006, there were a total of six F5 related shareholder derivative actions pending before this Court: (1) Hutton v. McAdam, et al. (Case No. C06-794RSL); (2) Wright v. Amdahl, et al. (Case No. C06-872RSL); (3) Adams v. Amdahl, et al. (Case No. C06-873RSL); (4) Locals 302 and 612 of the Int'l Union of Operating Eng'rs-Employers Constr. Indus. Ret. Trust v. McAdam, et al. (Case No. 06-1057RSL) (hereinafter "Locals Trust"); (5) Easton v. McAdam, et al. (Case No. C06-1145RSL); and (6) Sommer v. McAdam, et al. (Case No. C06-1229RSL). On September 12, 2006, the Court remanded the Wright and Adams actions to King County Superior Court, and on September 28, 2006, the Court signed an order granting the parties' stipulation for remand in Sommer. See Dkt. #22 in C06-872; Dkt. #34 in C06-873; and Dkt. #18 in C06-1229. Wright, Adams, and Sommer were consolidated in King County Superior Court before the Honorable William L. Downing and have been stayed pending the federal court actions (see King County Superior Court Nos. 06-2-17195-1SEA; 06-2-19159-5SEA; and 06-2-

26248-4SEA). On October 2, 2006, the Court signed an order on the parties' stipulation in Hutton, Locals Trust, and Easton, consolidating these actions for all purposes, appointing lead plaintiff and lead counsel, and setting the schedule for filing a consolidated complaint. See Dkt. #37 in C06-794. Under this order, Locals 302 and 612 of the International Union of Operating Engineers-Employers Construction Industry Retirement Trust (hereinafter "Locals 302 and 612" or "lead plaintiff") was appointed lead plaintiff charged with filing a consolidated complaint. Id. at 3. On November 20, 2006, lead plaintiff filed a "Consolidated Verified Shareholders Derivative Complaint" (Dkt. #39) (hereinafter the "Complaint"). On February 28, 2007, F5 filed a motion to dismiss for failure to make demand. See Dkt. #49. On August 6, 2007, the Court granted the motion to dismiss with leave to amend because the Court found that it would not have been futile for plaintiffs to make a pre-litigation demand on F5's directors. See Dkt. #69 (Order Granting Nominal Defendant F5 Networks, Inc.'s Motion to Dismiss for Failure to Make Demand). On September 14, 2007, plaintiffs filed an amended consolidated verified shareholder derivative complaint. See Dkt. #74. F5 moved again to dismiss the complaint contending demand was not excused, and this motion is now pending before the Court for consideration. See Dkt. #80.

B. Analysis

1. Washington has not established a substantive demand futility standard.

In this shareholder derivative action, F5 moves for a second time to dismiss plaintiffs' suit for failure to make pre-litigation demand on F5's board of directors. The purpose of a derivative action is to "place in the hands of the individual shareholder a means to protect the interests of the corporation from the misfeasance and malfeasance of faithless directors and managers." Kamen v. Kemper Fin. Serv., Inc., 500 U.S. 90, 95 (1991) (quotation marks and citation omitted). To prevent abuse of this remedy, however, shareholder derivative complaints are governed by the pleading requirements of Fed. R. Civ. P. 23.1(b), which states, in part: "[t]he complaint must . . . (3) state with particularity: (A) any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and (B) the reasons for not obtaining the action or not making the effort." Id. In this case, plaintiffs do not allege that they made a demand on F5's board of directors. Instead, plaintiffs claim that demand was excused because it would have been futile. See, e.g., Dkt. #74 at ¶175 ("A pre-filing demand would be a useless and futile act").

"[A] court that is entertaining a derivative action . . . must apply the demand futility exception as it is defined by the law of the State of incorporation." Kamen, 500 U.S. at 108-109; In re Silicon Graphics Inc. Securities Litig., 183 F.3d 970, 990 (9th Cir. 1999) ("For [demand futility] standards, we turn to the law of the state of incorporation"). F5 was incorporated in Washington State, so Washington law applies on this issue. Washington has a procedural demand requirement set forth in RCW 23B.07.400(2), "Derivative proceedings procedure," which states:

> A complaint in a proceeding brought in the right of a corporation must be verified and allege with particularity the demand made, if any, to obtain action by the board of directors and either that demand was refused or ignored or why a demand was not made. Whether or not a demand for action was made, if the corporation commences an investigation of the charges made in the demand or complaint, the court may stay any proceeding until the investigation is complete.

Although RCW 23B.07.400(2) sets forth the procedural demand requirement, Washington courts have neither interpreted this provision nor adopted a substantive demand requirement.[1] See Kamen, 500 U.S. at 96 ("[T]he demand doctrine . . . clearly is a matter of 'substance' not 'procedure.'"). But, it is clear under Washington law that "[d]erivative suits are disfavored and

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[1] At oral argument on August 1, 2007, F5's counsel noted the absence of Washington law concerning the substantive standard for when demand is excused. See Dkt. #84 (Transcript of proceedings) at 3:21-4:6 (F5's counsel stating, "We have here a federal judge [the undersigned] sitting in Washington applying Washington law because F5 is a Washington company, and we don't have a lot of Washington law. So the federal . . . Washington courts, also borrow substantially from Delaware but in this instance, we also have a substantial body of law that is developed in part because the Northern District of California has been the center of many of the decided cases. And those cases, I think, shed good light on how this Court should approach the interestedness element since it doesn't have much to look at in Washington law directly.") (emphasis added).

may be brought only in exceptional circumstances." Haberman v. Wash. Pub. Power Supply Sys., 109 Wn.2d 107, 147 (1987).

Courts in the Western District of Washington have generally assumed "the Washington State Supreme Court would likely adopt the substantive demand requirement and apply a similar, if not the same, exception for futility as that employed in Delaware." See In re Cray, 431 F. Supp. 2d 1114, 1120 (W.D. Wash. 2006); accord Schwartzman v. McGavick, 2007 U.S. Dist. Lexis 28962, at *12 (W.D. Wash. April 19, 2007) (citing In re Cray, 431 F. Supp. 2d at 1120 and following Delaware law given the parties' agreement); Fernandes v. Bianco, 2006 U.S. Dist. Lexis 42048, at *7 (W.D. Wash. June 22, 2006) (same).

In the August 6, 2007 order, this Court also looked to Delaware's substantive demand futility standard as persuasive authority. See Dkt. #69 at 9 ("Following In re Cray, the parties agree that Delaware's substantive demand requirement is persuasive authority here."). The Court then applied the Aronson v. Lewis, 473 A.2d 805 (Del. 1984) test to the facts as alleged in the complaint and found that it would not have been futile for plaintiffs to make a pre-litigation demand on F5's directors and therefore granted defendants' motion to dismiss but with leave to amend. Id.

The extent to which this Court should follow Delaware law has now come to a critical juncture in this case with the filing of plaintiffs' amended complaint and F5's second motion to dismiss because the degree to which this Court follows Delaware's substantive demand futility standard is potentially outcome determinative. In order for the Court to decide whether this matter should proceed, the Court needs to determine two threshold questions. First, the Court must decide the extent to which Washington follows Delaware's substantive standards for when demand is excused as announced in Aronson and Rales v. Blasband, 634 A.2d 927 (Del. 1993). Second, assuming Washington follows these Delaware decisions, the Court must determine the extent to which Washington follows the demand futility standard as articulated in Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007) in the specific context of a derivative action alleging stock option "backdating." As discussed below, however, the Court in its discretion determines that because F5 is a Washington corporation, both of these determinations are best considered through certification to the Washington State Supreme Court as authorized by RCW 2.60.020.

2. Does Washington follow Delaware's general demand futility standard?

Under Delaware law, there are exceptions to the demand requirement that flow from the two landmark Delaware Supreme Court decisions in Aronson and Rales. In Aronson, the Delaware Supreme Court promulgated the two-part "Aronson test," which holds that demand is futile and excused where "under the particularized facts alleged, a reasonable doubt is created that (1) the directors are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment." Aronson, 473 A.2d at 814-15. If either part of the test is satisfied with respect to half or more of the board members at the time the complaint was filed, demand is excused. See Beneville v. York, 769 A.2d 80, 85-86 (Del. Ch. 2004). Under Rales, the Delaware Supreme Court rejected the application of the Aronson test when the board of directors upon which demand would be made did not approve the challenged transaction. In these situations, demand is excused if the well-pleaded allegations in the complaint give rise to reasonable doubt that the board can exercise "its independent and disinterested business judgment in responding to a demand." Rales, 634 A.2d at 933-34; see also Conrad v. Blank, 940 A.2d 29, 37 n.17 (Del. Ch. 2007).

Federal district courts, including the Court in this case, have assumed without direction from the Washington Supreme Court that the Supreme Court would likely adopt Delaware's substantive demand futility standard. Without instruction from the Washington Supreme Court, however, this assumption is speculation.[2]

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[2] See, e.g., Boland v. Engle, 113 F.3d 706, 712 (7th Cir. 1997) ("Although Delaware corporate law is undoubtedly persuasive authority, Boland's argument that the Indiana Supreme Court would follow Delaware . . . is not convincing. Rather, we surmise that the highest court in Indiana would today be persuaded by the general trend in the law towards narrowing, if not eliminating, the exceptions from the demand requirement. Eleven states have statutorily imposed a universal demand requirement. And both the case law and the academic commentary have been moving strongly in that direction as well.")

3. If Washington follows Delaware, does Washington also follow Ryan v. Gifford in cases where the improper "backdating" of stock options has been alleged?

In derivative actions alleging the improper "backdating" of stock options, there are two general approaches courts have taken concerning the pleading standard to determine whether demand was excused: (1) the approach taken in Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007), and (2) the approach taken in cases like In re CNET Networks, Inc. S'holder Derivative Litig., 483 F. Supp. 2d 947, 958 (N.D. Cal. 2007) that distinguish Ryan and engage in a searching inquiry into the individual option grants at issue.

This Court in its August 6, 2007 order chose the latter approach and engaged "in a detailed, grant-specific analysis" and ultimately concluded based on this analysis that plaintiffs had failed to establish reasonable doubt that the option grants at issue had been "backdated." See Dkt. #80 at 5. The Court found that plaintiffs had not made a particularized showing, in part, because of the "lack of consistency in plaintiffs' claims." See Dkt. #69 at 23-24. In their amended complaint, plaintiffs have substantially cured the inconsistencies in their claims concerning alleged backdating. However, the alleged facts supporting their claims remain substantially the same as those alleged in their original complaint. As a result, the central issue before the Court on F5's second motion to dismiss is whether plaintiffs' allegations are sufficient under Washington law to demonstrate that demand was futile, which in turn, requires the Court to determine the extent to which the Washington Supreme Court would adopt the Ryan analysis in the specific stock option backdating context. In Ryan, a Delaware trial-level court concluded:

> Plaintiff here points to specific grants, specific language in option plans, specific public disclosures, and supporting empirical analysis to allege knowing and purposeful violations of shareholder plans and intentionally fraudulent public disclosures. Such facts, in my opinion, provide sufficient particularity in the pleading to survive a motion to dismiss for failure to make demand pursuant to Rule 23.1

Ryan, 918 A.2d at 355 & n.34 ("Defendants argue repeatedly that plaintiff's allegations

(internal citations omitted).

ultimately rest upon nothing more than statistical abstractions. . . . Given the choice between improbably good fortune and knowing manipulation of option grants, the Court may reasonably infer the latter, even when applying the heightened pleading standards of Rule 23.1."); see Edmonds v. Getty, 524 F. Supp. 2d 1267, 1276 (W.D. Wash. 2007) ("This court does not find Getty Images' arguments persuasive; instead, it adopts the reasoning in Ryan and finds that Mr. Edmonds alleged facts sufficient to reasonably infer that backdating rather than innocent bookkeeping errors occurred."). In their response and amended complaint, plaintiffs assert that they have met the pleading requirement as set forth in Ryan and as adopted by Judge Robart in Edmonds. See Dkt. #86 at 11; Dkt. #74 (Amended Complaint) at ¶73 (stating "[a]s Chancellor Chandler articulated in his seminal decision in Ryan, a pattern of backdating is alleged with sufficient particularity when the dates, prices, recipients and the plan language violated are identified.").

C. Certifying a question to the Washington State Supreme Court is appropriate

RCW 2.60.020 provides:

> When in the opinion of any federal court before whom a proceeding is pending, it is necessary to ascertain the local law of this state in order to dispose of such proceeding and the local law has not been clearly determined, such federal court may certify to the supreme court for answer the question of local law involved and the supreme court shall render its opinion to answer thereto.

Based on the discussion above, the Court concludes that the appropriate course of action in this case is to certify a question to the Washington Supreme Court in accordance with RCW 2.60.020 because a substantive demand standard has not been established under Washington law and because the answer may be dispositive in this case. Furthermore, should the Washington State Supreme Court answer the certified question,[3] the answer will also have far-reaching effects given the recent number of shareholder derivative actions filed in this district,[4] and the

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[3] Whether to answer the certified question is within the discretion of the Washington State Supreme Court. See Broad v. Mannesmann Anlagenbau, A.G., 141 Wn.2d 670, 676 (2000).

[4] See, e.g., Sexton v. Van Stolk (Case No. 07-1782RSL).

state-court actions that have been stayed pending the outcome of this federal action.[5] See Keystone Land & Dev. Co. v. Xerox Corp., 353 F.3d 1093, 1097 (9th Cir. 2003) (concluding that the appropriate course of action was to certify the question because the issue was "not entirely settled in Washington, and because if clarified definitively by the Washington State Supreme Court, the answer will have far-reaching effects").

Generally, states have adopted one of three separate substantive demand tests. First, the majority of states that have considered the issue have adopted, either by statute[6] or by judicial decision,[7] what has been described as the "universal demand" requirement from the Model Business Corporation Act.[8] Second, other states look to Delaware's demand futility test as set

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[5] See Jeffrey S. Facter, Article: Fashioning a Coherent Demand Rule for Derivative Litigation in California, 40 Santa Clara L. Rev. 379, 381 n.9 (2000) (arguing for California to adopt its own clearly defined demand rule rather than adopting Delaware law on an ad hoc basis, and attributing the dearth of California case law on demand futility to the fact that the issue inherently evades ordinary appellate review because either (1) the motion to dismiss on demand futility is denied, in which case the litigation lasts for years before judgment is entered or the case is settled, or (2) if the motion to dismiss is granted there is an appealable order "but the plaintiff rarely has the incentive to take an appeal because the option of proceeding to make a demand on the board is a much lower cost alternative than prosecuting an appeal.").

[6] See, e.g., Ariz. Rev. Stat. § 10-742 (2008).

[7] See Cuker v. Mikalauskas, 692 A.2d 1042, 1050 (Pa. 1997); Drain v. Covenant Life Ins. Co., 712 A.2d 273 (Pa. 1998) ("In Cuker this Court adopted the American Law Institute Principles of Corporate Governance with respect to standing to maintain a derivative action. . . . The shareholder must make a written demand upon the corporation's board of directors and request it to prosecute the action or take corrective measures. Demand on the board is excused only if the shareholder shows that irreparable injury to the corporation would otherwise result, and the demand should be made promptly after commencement of the action. If irreparable injury would not result, the court should dismiss the derivative action that is commenced before the response of the board to a demand unless the board does not respond within a reasonable time.") (emphasis added).

[8] See Mod. Bus. Corp. Act § 7.42 (2005) ("No shareholder may commence a derivative proceeding until: (1) a written demand has been made upon the corporation to take suitable action; and (2) 90 days have expired from the date the demand was made unless the shareholder has earlier been notified that the demand has been rejected by the corporation or unless irreparable injury to the corporation would result by waiting for the expiration of the 90-day period."); see also Todd A. Murray & Lyndon F. Bittle, Article: Emerging Issues Raised by Derivative Shareholder Actions Involving

forth in Aronson and Rales. See, e.g., Shoen v. SAC Holding Corp., 137 P.3d 1171, 1184 (Nev. 2006) ("[W]e adopt the test described in Aronson, as modified by Rales"). Finally, Maryland, departing from Delaware law, crafted its own "very limited exception" test.[9]

In its motion, F5 asserts that the demand futility standard set forth in the Court's August 6, 2007 order is the binding "law of the case" for purposes of analyzing plaintiffs' amended complaint. See Dkt. #80 at 5-6 ("The Order is now the law of the case, and there is no reason or basis whatsoever to revisit or change the well-reasoned demand-futility standards the Court has established.") (citing United States v. Alexander, 106 F.3d 874, 877 (9th Cir. 1997); Dkt. #89 at 2 ("The Court did not err, and there are no grounds for reversing the law of the case, as clearly established by the Court in its Order."). The law of the case doctrine, however, does not trump the certification process under the circumstances here. The authorizing statute, RCW 2.60.020, does not require certification at the beginning of the litigation or preclude certification after the Court has issued interlocutory rulings: as long as the proceeding is still pending in the district court, certification remains an option. The district court's power to reconsider or revise prior orders is limited by the law of the case doctrine only where the court has been divested of jurisdiction over the matter or has unduly delayed reconsideration.

> The law of the case doctrine is not an inexorable command, nor is it a limit to a court's power. Rather, application of the doctrine is discretionary. . . . The law of the case doctrine is wholly inapposite to circumstances where a district court seeks to reconsider an order over which it has not been divested of jurisdiction. . . . *All rulings of a trial court are subject to revision at any time before the entry of*

Foreign Corporations Headquartered in Texas: Making Sense of the Interaction Between Texas Procedures and Substantive Law, 39 Tex. Tech. L. Rev. 1, 15-16 (2006) (discussing the fact that Texas and at least 20 other states have adopted section 7.42 of the Model Act).

[9] See Werbowsky v. Collomb, 362 A.2d 123, 144 (Md. 2001) ("We adhere for the time being, to the futility exception, but, consistent with what appears to be the prevailing philosophy throughout the country, regard it as a very limited exception, to be applied only when the allegations or evidence clearly demonstrate, in a very particular manner, either that (1) a demand, or a delay in awaiting a response to a demand, would cause irreparable harm to the corporation, or (2) a majority of the directors are so personally and directly conflicted or committed to the decision in dispute that they cannot reasonably be expected to respond to a demand in good faith and within the ambit of the business judgment rule.").

> *judgment*. . . . The doctrine simply does not impinge upon a district court's power to reconsider its own interlocutory order provided that the district court has not been divested of jurisdiction over the order.

United States v. Smith, 389 F.3d 944, 949 (9th Cir. 2004) (internal citations and quotation marks omitted, emphasis in cited case). The Smith court distinguished the case upon which F5 relies, United States v. Alexander, 106 F.3d 874 (9th Cir. 1997), on the ground that reconsideration in that case was untimely granted only after the jury was unable to reach a verdict and the court had declared a mistrial. Accordingly, F5's argument concerning the binding effect of the Court's August 6, 2007 order is not relevant in the Court's discretion to certify a question regarding the applicable demand futility standard to the Washington Supreme Court as authorized by RCW 02.60.020.

III. CONCLUSION

Based on the reasoning above, the parties are ORDERED TO SHOW CAUSE why the following question should not be certified to the Washington State Supreme Court under RCW 2.60.020:

> "What test does Washington apply to determine whether allegations made pursuant to RCW 23B.07.400(2) by a shareholder seeking to initiate derivative litigation on behalf of a Washington corporation excuse that shareholder from first making demand on the board of directors to bring that litigation on behalf of the corporation?; and
>
> If Washington follows Delaware's demand futility standard, does it also follow the reasoning of Ryan v. Gifford, 918 A.2d 341 (Del. Ch. 2007) in cases where the improper backdating of stock options has been alleged?"

The parties shall SHOW CAUSE in response to this ORDER on or before **Friday, June 6, 2008** in a filing not to exceed 12 pages. The Clerk is directed to place this Order to Show Cause on the Court's calendar for Friday, June 6, 2008.

DATED this 20th day of May, 2008.

Robt S Lasnik

Robert S. Lasnik
United States District Judge

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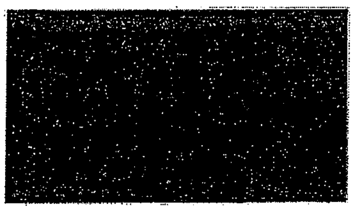
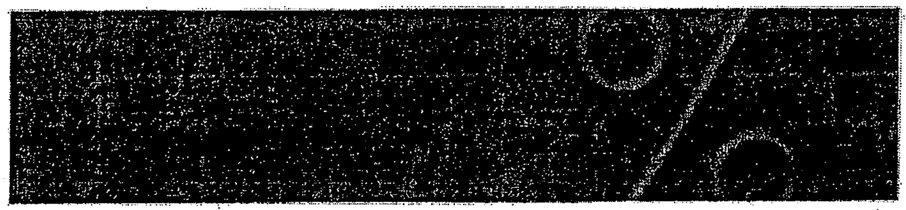
NERA
Economic Consulting

Options Backdating: The Statistics of Luck

Part III of A NERA Insights Series

By Dr. Renzo Comolli, Dr. Branko Jovanovic, Dr. Patrick Conroy, and Erik Stettler





See Table 2 (on page 9) for an updated list of companies involved in options backdating

Forthcoming topics in this options backdating series will include:

- In-Depth Statistics

Misconceptions about Backdating and Probability

In this article, we explain why:

- some patterns of option grants that may appear extremely unlikely are actually very likely;
- the calculations presented in the March 18, 2006 *Wall Street Journal* article can be misleading; and
- factors that were disregarded in published probability calculations may be especially important when estimating the likelihood of grants for specific companies.

Allegations of Backdating

Allegations of backdating typically involve a claim of practice by which companies look back to past stock prices and record option grants on a date prior to the actual date of the grants—a date in which the stock price was low.

According to these allegations, companies were motivated by two goals. The first goal was to report granting options with a strike price equal

Backdating:
Refers to the claim that employee stock options were granted on a date (the backdated grant date) preceding the date in which they were actually granted. A typical allegation is that:

1. The strike price is set equal to the stock price on the date of the (backdated) grant
2. The stock price on the (backdated) date is lower than the stock price on the (actual) date of the grant

Springloading:
Refers to the practice of granting options ahead of good-news and/or withholding good news until employee stock options are granted.

EXHIBIT A

to the stock price on the day of the grant—a goal motivated by accounting and taxation rules.[1] The second goal was to grant options to provide remuneration to the employees who receive them—one way to increase the value of the options to the employees is to grant them with a strike price lower than the stock price of the day in which the grant is issued.[2] In finance parlance, according to the allegation, these companies granted options that were "at the money" on paper, while, in fact, the options were "in the money."[3]

What the Academics Are Saying About Stock Price Patterns around Grant Dates

Aggregate Patterns

The academic literature so far has focused on aggregate patterns across publicly traded companies, not on individual companies. The academic literature on backdating is designed to detect whether the aggregate pattern of stock price movement close to grant dates is inconsistent with an assumed benchmark, not whether an individual company has engaged in backdating. The benchmark that the academic literature has assumed, sometimes explicitly, sometimes implicitly, is that grants were made on a random day. This benchmark is analogous to saying that the grant date is determined by a process similar to that used to select the winning number in the Powerball lottery or to toss a coin. That is, the company randomly picks from trading days when selecting the day of the option grant, regardless of past prices or expectation of future prices.

Different authors have indeed investigated option grant timing and have found varying results *(see table in the appendix for details)*

Lie (2005) finds that, in the aggregate, stock prices tend to decline prior to grant dates and increase immediately after grant dates. Lie speculates that the explanation for this price pattern lies in backdating. Other authors who have investigated stock price movements around option grants find results that in part correspond to and are in part at odds with Lie's findings. These other works propose a different explanation for their findings: insiders manipulate information releases around the grant dates, a practice sometimes referred to as springloading. The academic articles do not, and could not, given the methodologies that they use, find proof of backdating, springloading or similar practices; they find, or claim to find, aggregate price patterns that are consistent with those practices being adopted by at least some companies.

Currently Available Academic Literature on Option Timing Does Not Disentangle Legal from Illegal Practices

Current academic literature uses methodologies that are not designed to determine whether an individual company has engaged in backdating. They are designed to detect aggregate patterns, but do not directly analyze specific companies. To our knowledge, no published academic study has addressed the likelihood of grants of specific companies. As one of the academic authors explains, his analysis *"is designed to uncover evidence of retroactive timing in the aggregate, and might be useless in identifying exactly which firms engage in such activities"* Lie (2005).

The Probability of Grants

What Is the Benchmark to Determine Whether a Grant Is Likely or Unlikely?

The assumption made by academic articles and popular press that, in the absence of backdating, a company would randomly grant options throughout the year (according to the Powerball method) is problematic. Rather than randomly granting options, companies may be more likely to grant options on days in which they perceive their stock to be undervalued. This could lead to a pattern where the price increases after grants would be better than random even in the absence of backdating. Similarly, one would expect to find a price pattern different from random in cases where a company offers employees a bonus paid in option grants if certain production deadlines are reached and announced to the public. These possibilities apply both to the study of aggregate patterns and to the study of individual companies; we return to this topic on page 6.

Some Patterns of Options Grants That May Appear Very Unlikely Are Actually Very Likely

On March 18, 2006, the *Wall Street Journal* published an article entitled "The Perfect Payday" singling out seven companies that according to the *Journal* exhibited "wildly improbable option-grant patterns." Yet some grant patterns that may appear extremely unlikely at first sight are actually very likely and should be expected.

[1] Companies may grant options at the strike price of their choosing, regardless of the stock price.

[2] The increase in value is an increase only in the potential value of the option and might not ultimately translate into any increase in value at all if the option is not exercised.

[3] An option is said to be at the money on a certain day if its strike price is equal to the stock price on that day; if the strike price is lower than the stock price, the option is said to be in the money.

To illustrate the tricky issues associated with identifying backdating in individual companies, we will set aside for the moment the fact that some companies may issue option grants when they perceive their own stock to be undervalued (that is, we set aside the issue of the appropriate benchmark). Rather, we adopt the assumption that companies are equally likely to grant on any trading day within a year and show that even under this (the Powerball) assumption some grants that may appear unlikely are actually very likely.

Probability theory indicates that if companies were granting options using the Powerball method, we would observe grants on days on which the stock price is at a relative low, on days on which the stock price is at a relative high, and on days on which it is in-between

Probability theory also implies that if the companies granted options using the Powerball method for each grant, by chance, some companies would grant on a day with a relatively low strike price for most or all of their grants. This can be counterintuitive. Behavioral Economics, an increasingly influential branch of Economic science, has shown that people often erroneously expect random draws to be neither very lucky, nor very unlucky. (*See sidebar, right.*) Similarly, people might expect a company randomly selecting grant dates to select dates on which the price is neither too high nor too low overall However, statistical theory states that when many companies select grant dates at random, some will select dates on which the strike price is at a very low point on many occasions.

The *Wall Street Journal* did not account for the fact that there is a large number of directors and officers (D&O) in the United States who receive grants [4] With such a large number of D&O, it was practically certain that some of them would receive most of their grants on days in which the stock price was particularly low, even just by chance.[5] *(See side bar, "The woman who won the lottery twice")*

For example, take a hypothetical Ms X who received one grant a year for 4 years and that those grants fell on the 1st, 5th, 50th, and 3rd most favorable day in their respective year. The probability of Ms. X receiving grants more favorable than what she received is only 1 in a million, when computed according to the *Wall Street Journal*'s method.[6] Once we compute the probability of there being at least one Ms X among all D&O receiving grants in the United States, we find that actually it was practically sure that there would be somebody like Ms. X among them—the probability of there being somebody like Ms. X is actually 99.9%.

In the Same Way in Which There Are Companies That Granted on Very Favorable Days, There Are Companies That Granted on Very Unfavorable Days

As mentioned above, probability theory implies that some companies would grant on days that are consistently good and others on days that are consistently bad, even with the Powerball method. We performed our own analysis that confirmed that to be true for US companies. We analyzed grant patterns for US companies

A common misconception about luck

A simple coin toss example illustrates a misconception about luck Academic research has shown that, when looking at repeated coin tosses, "people regard sequence H-T-H-T-T-H to be more likely than the sequence H-H-H-T-T-T, which does not appear random, and also more likely than the sequence H-H-H-H-T-H, which does not represent the fairness of the coin." In reality, the probability of either sequence of heads and tails being drawn at random is exactly the same.[†]

[†] Cited in Daniel Kahneman, Paul Slovic, Amos Tversky (1982) *Judgment under Uncertainty: heuristics and biases*, Cambridge University Press.

[4] When mentioning D&O, we actually refer to all who had to file forms 3, 4, and 5 with the Securities and Exchage Commission.

[5] Additionally, The *Wall Street Journal* explicitly stated that it pre-selected "companies that made stock-option grants that were followed by large gains in the stock price," thereby introducing a distortion called sample selection bias

[6] Below we explain what is meant by "favorable day," how the *Wall Street Journal* arrives at its numbers, and the correction that we make to its calculation The correction alone increases the probability approximately 100 times.

The woman who won the lottery twice

A woman who won the New Jersey lottery twice in a four-month period prompted the following front-page story in the *New York Times:*†

> "Defying odds in the realm of the preposterous-- 1 in 17 trillion—a woman who won $3.9 million in the New Jersey state lottery last October has hit the jackpot again."

Two Harvard statisticians reviewed this news story in an article published by the Journal of the American Statistical Association on methods for studying coincidences.†† They concluded that "[t]he 1 in 17 trillion number is the correct answer to a not-very-relevant question." We agree with them. A relevant question is the likelihood that *someone* is a double winner over a given span of time; according to their article "it is better than even odds to have a double winner in seven years somewhere in the United States."

This sort of misunderstanding is widespread in the current debate on options backdating. The Wall Street Journal's calculations that purport to show the likelihood of some grant patterns are actually not very relevant

† *New York Times* February 14, 1986 "Odds-Defying Jersey Woman Hits Lottery Jackpot 2d Time" by Robert D McFadden

†† Persi Diaconis and Frederick Mosteller (1989) "Methods for Studying Coincidences", *Journal of the American Statistical Association*, Vol 84 No 408.

that granted options in the period 1995 through August 2002.[7] We focused on at-the-money grants [8]

Following the *Wall Street Journal's* approach, we calculated the 20-day stock price return after each trading day in the year and ranked them. For a year with 252 trading days, if a grant fell on the day followed by the highest 20-day return, it would have a probability of 1 in 252 of occurring by chance Likewise, the chance of the grant occurring on the day of the year ranked eighth or higher would be 8 in 252. For each company, we then averaged the ranks associated with each grant. Figure 1 (see next page) shows all companies and the average rank of their grants.

For example, the figure shows that there are companies with an average rank between 6 and 12. Informally, people would say that these companies have been very lucky. The figure also shows that some companies have an average rank between 240 and 246 (that is, their grants rank on average between the 6th and 12th **worst** day of the year). Informally, people would say that these companies have been very unlucky. Speculation has been rampant about companies that have been very lucky; yet nobody has been paying any attention to companies that have been very unlucky. Probability theory tells us that chance alone can produce both very lucky and very unlucky companies, and indeed we see that there are some of both types.

Consistent with some of the academic findings, Figure 1 also shows that the aggregate pattern of returns for US companies is more favorable than what granting based on the Powerball method would suggest. Specifically, there are more companies that do better than 50% (ranked about 126) than there are companies that on average do worse than 50%. This brings us back to the fact that some companies presumably issue grants when they perceived their stock to be undervalued, while some companies have admitted to engaging in backdating. Thus our finding, very much like the academic literature, does not disentangle legal from illegal practices.

The Calculations Presented in the March 18, 2006 *Wall Street Journal* Articles Can Be Misleading

We also performed our own analysis of the probability that D&O could have received grants more favorable than the ones they actually received to compare it with the *Wall Street Journal's* analysis.[9]

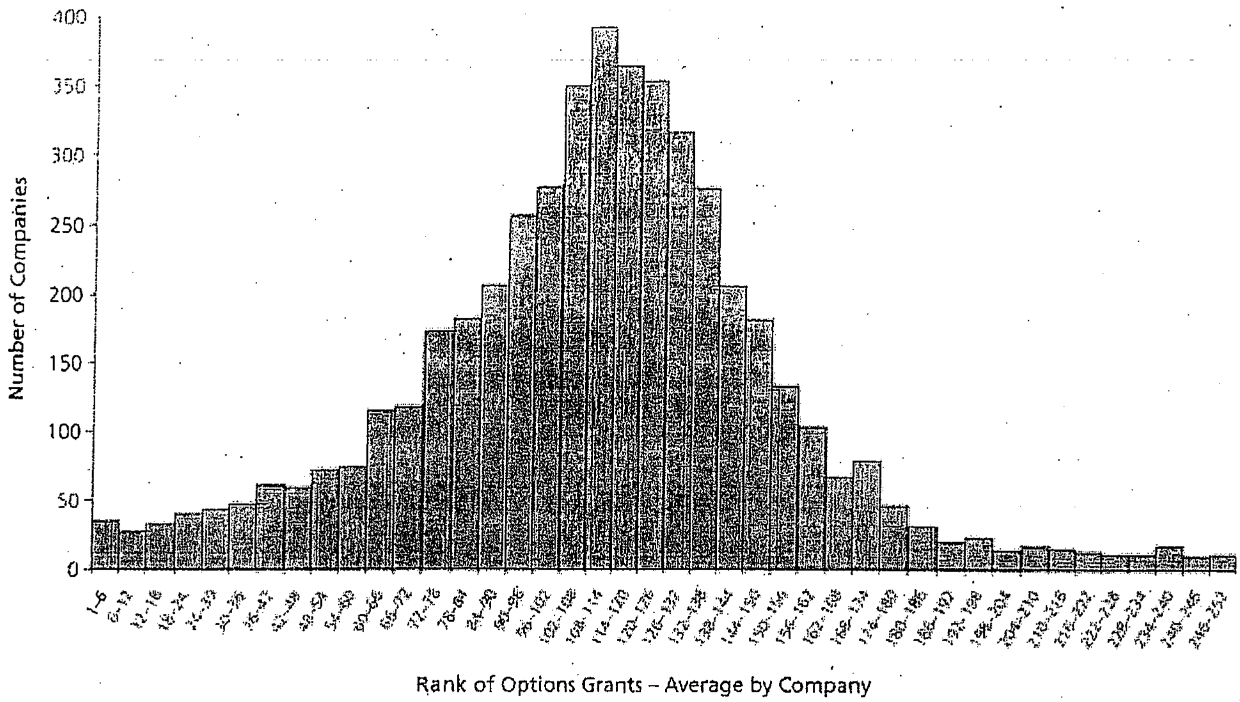
Let's consider the case of a person who received two grants: one ranking 1 out of 252 and one ranking 8 out of 252; what is the probability of receiving grants that are more favorable than that? It is our understanding that the *Wall Street Journal's* methodology underestimates (sometimes severely) the probability of receiving grants more favorable than the ones actually received and it can therefore be misleading. *The Wall Street Journal* considers a pattern of grants to be more favorable than the

[7] In August 2002 the passage of Sarbanes-Oxley drastically reduced the time period in which grants must be reported to the SEC.

[8] Like the academic studies, we analyzed those grants that we could match to stock prices.

[9] We followed the *Wall Street Journal* approach for all but an important correction We made only this correction, not because we think that that is the only correction to be made, but because making only one correction allows us to highlight a very important point We come back to other methodological considerations on page 6

Figure 1. Average Rank of Option Grants by Company, Rank Based on 20-Day Stock Price Return (January 1995–August 2002)



Note: Stock price increases are ranked within each year and within each company. A rank of 1 indicates the largest price increase in the year for each company. A rank of 252 indicates the largest price decline of the year for each company. Years that have a number of trading days different from 252 have been rescaled to 252.

actual grants received, if each single alternative grant is more favorable than each single grant actually received, i.e. if each single grant falls on a day of the year ranked either the same or higher than each single actual grant.[10] If everybody in the United States received multiple grants at random (with the Powerball method), the *Wall Street Journal*'s calculations would result on average in people having less than 50% probability of having received their grants at random; i.e., *Wall Street Journal* underestimates that probability. For example, if everybody were to receive 10 grants using the Powerball method, the average probability of receiving grants that are better than the ones actually received, computed using the Journal's method, is 9%—quite far from the 50% that we would expect on average for random grants.

The underestimation happens because the *Wall Street Journal*'s methodology is inconsistent in its ranking of grant patterns. As an example, compare the following two hypothetical D&O insiders:

- Mr. A received 3 grants (1 per year) ranked respectively 1, 2 and 3 out of 252
- Ms. B also received 3 grants (1 per year), each of them ranked 2 out of 252

When computing the probability of receiving grants that are more favorable than the ones that Mr. A received, Ms. B's grants are counted by the Journal as less favorable (because Ms. B's first grant was not as favorable as Mr. A's), but when computing the probability of receiving grants that are more favorable than the ones that Ms. B received, Mr. A's grants are counted by the Journal as less favorable (because Mr. A's third grant was not as favorable as Ms. B's). So, according to the Journal, Mr. A is at once both better off and worse off than Ms. B.

10 *The Wall Street Journal* allows for the order of the grants to be different.

We corrected just this feature of the *Wall Street Journal's* method so that if everybody were to receive grants using the Powerball method, the average probability of receiving grants that are more favorable than the ones actually received is 50% [11] The next figure compares the probabilities of the grants computed according to the *Wall Street Journal* method (in gray) and those computed after we correct their method (in blue) for all D&O in the United States.

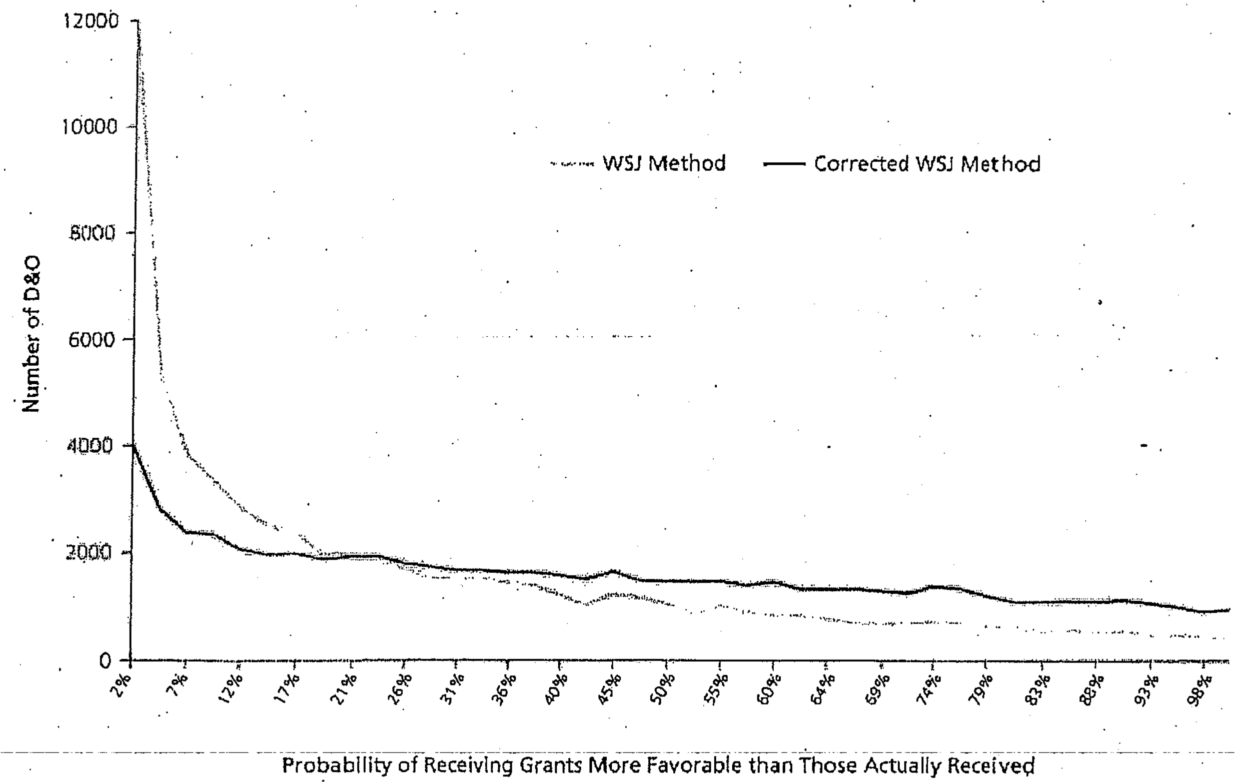
As we can see, the *Wall Street Journal's* method significantly understates the probability of grants for D&O. Less formally, it significantly *overstates* the number of D&O that have been very lucky. For example, Figure 2 shows that, according to the *Wall Street Journal's* method, the number of D&O who had a 2% probability of receiving grants more favorable than those actually received is three times as large as the number of D&O obtained using the corrected method. Also, according to the *Wall Street Journal's* method the median D&O had a probability of 18% of receiving grants more favorable than the one that he or she actually received, while the same probability is 38% according to the corrected method.

Factors That Were Disregarded In Published Probability Calculations and That May Be Important When Estimating the Likelihood of Grants for Specific Companies

What Probability to Estimate?

In the previous section, we adopted the same methodology as the *Wall Street Journal* and we corrected it only in one aspect. Yet, there are many other aspects that need attention These aspects may affect the analysis of aggregated price patterns and they may radically change probability calculations for specific companies. Without attempting to be

Figure 2. *The Wall Street Journal's* Method of Computing the Probability of Receiving Grants More Favorable than Those Actually Received Can Be Misleading (January 1995–August 2002)



[11] For each D&O, we averaged the ranks associated with each grant. That is, if a D&O received a grant on a day ranked No. 8 out of 252 and another grant on a day ranked No. 6 out of 252, we associated to the D&O an average of 7 out of 252. We then computed the probability of receiving grants that are better than that

comprehensive, we turn to some of those here.

One consideration is the length of the window on which to compute returns. The literature has used various measures; for example, the *Wall Street Journal* uses the 20-day window following the grant, a measure it refers to as "arbitrary."

Another consideration is whether one should use the actual return for a given day or its rank to assess the likelihood of the grant pattern. These two methods may yield different results; which one is more appropriate may depend on the details of the decision making process within each company.

A further consideration is whether the number of options issued in each grant should be taken into account. For instance, an executive may have been very lucky on an occasion where only a modest number of shares were issued and unlucky on an occasion where a large number of shares were issued. Considering the number of options granted may yield different results.

On What Alternative Dates Could the Grant Have Been Issued?

When assessing the probability of a particular grant, the grant date is compared to other days. The *Wall Street Journal*, for instance, compares grant dates against all other trading dates in a year in which the grant was issued. This, however, may overstate the number of "available comparison" dates. Even before Sarbanes-Oxley, a very large number of grants were reported to the Securities and Exchange Commission in form 4, which required that a grant be reported, not within one year, but within 10 days after the end of the month of the grant. Therefore the type of form that the insider filed as well as the relationship between the date of filing and the reported grant date may inform which days are the suitable comparators to actual grant date.

Scheduled Grants

Scheduled grants cannot be backdated. Some academic authors have taken this specifically into account and noted that grants that are always filed on the same date can hardly be prone to backdating. One needs to consider that scheduled grants may not necessarily always fall on the same calendar day; for instance a scheduled grant may always fall on the first Monday of the fiscal quarter.

To our knowledge, nobody has so far taken into account that grants may be scheduled even if they fall on different dates every year. This can happen when grants are linked to corporate events, such as earning announcements or certain corporate governance meetings. These scheduled grants too, like the fixed-date scheduled grants, can be difficult or impossible to backdate.

Grants for Events That Are Good News for the Company

Another potential factor that, to the best of our knowledge, has not been taken into consideration is that grants may be issued to employees for the accomplishment of corporate milestones that the market interprets as good news.

For example, grants could be made for the appointment of a new CEO, the promotion of an officer, the licensing of a patent, reaching a production goal, or a business deal. In all these examples, the stock price may rise after the grant because of the market assessment of the event, rather than of the grant. Since options are often parts of compensation packages, grants on occasions of new D&O appointments are likely.

Investors May Buy After the News of the Grant Reaches the Market

If, in fact, companies are more likely to issue grants when they perceive their stock to be undervalued, investors may take the news of a grant as a signal to purchase the stock, thereby causing the price increase. Therefore, a high return following a grant may be a result of an increase in demand for the stock of the issuing company by investors. Thus, it may be appropriate to disentangle the price movement after a grant from the price movement after the news of a grant is on the market.

What's Next?

A lot of misconceptions have been circulating about options backdating and in particular about the statistical calculations that have been used in connection with it. On the one hand, the academic literature studying aggregate price pattern following option grants is comparatively recent and no methodology to disentangle illicit practices from legitimate ones has consolidated yet. On the other hand, we have discussed and presented corrections for some conceptual errors regarding the probability calculations concerning specific companies or specific insiders. Each new case may present some specific characteristic that challenge economists to rethink their method to arrive to the correct conclusion.

Appendix

Table 1. Academic Literature on the Alleged Manipulation of Employee Stock Option Grants

	Data Source	Type of Grants	Practice Investigated
Yermack, David. *Good Timing: CEO Stock Option Awards and Company News Announcements*. The Journal of Finance, Vol. LII, No. 2 June 1997	Annual proxy statements from Fortune 500 companies	Unscheduled, scheduled, and unclassified	Springloading
Aboody, David & Kasznik, Ron. *CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures*. Journal of Accounting and Economics, 29 (2000) pp. 73–100	ExecuComp and annual proxy statements	Scheduled	Springloading
Chauvin, Keith W. & Shenoy, Catherine. *Stock Price Decreases Prior to Executive Stock Option Grants*. Journal of Corporate Finance, Vol. 7 (2001) pp. 53–76	Forms 4 and 5; CEOs obtained from Forbes compensation survey	Unscheduled	Springloading
Narayanan, M.P. and Seyhun, H. Nejat. *Do Managers Influence Their Pay? Evidence from Stock Price Reversals Around Executive Option Grants* (Mimeo, version dated January 2005)	Filings by insiders to meet Section 16(a) requirements	Unscheduled, scheduled, and unclassified	Backdating, springloading and bullet-dodging
Lie, Erik. *On the Timing of CEO Stock Option Awards*. Management Science, Vol. 51, No. 5, May 2005, pp. 802–812	Standard & Poor's ExecuComp database	Unscheduled, scheduled, and unclassified	Backdating
Lie, Erik & Heron, Randall A. *What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?* (Mimeo, version dated July 14, 2006)	Thomson Financial Insider Filing database	Unscheduled, scheduled, and unclassified	Backdating
Bebchuk, Lucian, Grinstein, Yaniv and Peyer, Urs. *Lucky CEOs* (Mimeo, version dated November 16, 2006)	Thomson Financial Insider Filing database	Unscheduled	Backdating and springloading
Bebchuk, Lucian, Grinstein, Yaniv and Peyer, Urs. *Lucky Directors* (Mimeo, version dated December 2006)	Thomson Financial Insider Trading database	Unscheduled, scheduled, and unclassified	Backdating and springloading
Narayanan, M.P., Schipani, Cindy A., & Seyhun, H. Nejat. *The Economic Impact of Backdating of Executive Stock Options*. Forthcoming in the Michigan Law Review (Vol. 105, Issue 8, June 2007).	SEC filings and from Thomson Financial Insider Filing database; firms from *Wall Street Journal* options scorecard	Unscheduled, scheduled, and unclassified	Backdating
Lie, Erik & Heron, Randall A. *Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?* Forthcoming in the Journal of Financial Economics	Thomson Financial Insider Filing database	Unscheduled	Backdating and springloading

Table 2. Companies Involved in Options Backdating: Disclosures and Lawsuits'

	Company	Value of In-The-Money Options'	Lawsuits: Class Action'	Lawsuits: Derivative'	Disclosures: SEC or DOJ Investigation'	Disclosures: Restatement or Charges'	Disclosures: Internal Investigation'	Disclosures: Executive Departure'
1	Able Energy	NA			x			
2	Actel	$ 7.84		x	x	x	x	x
3	Active Power	NA				x	x	x
4	Activision	66.45		x	x	x	x	
5.	Adobe Systems	56.[illegible]				x	x	
6	Affiliated Computer Services	46.84		x	x	x	x	x
7	Affymetrix	NA		x		x	x	
8	Agile Software	NA		x		x	x	
9	Alkermes	NA		x	x	x	x	
10	Altera	86.62		x	x	x	x	x
11	American Technology	NA				x	x	
12.	American Tower	NA	x	x	x	x	x	
13.	Amkor Technology	NA	x	x	x	x	x	
14.	Analog Devices	99.96		x	x			
15	Apollo Group	41.36	x	x	x	x	x	x
16.	Apple	48.45	x	x	x	x	x	x
17.	Applied Micro Circuits	114.92		x	x	x	x	
18.	Applied Signal Technology	NA					x	
19.	Arbinet	NA				x	x	
20.	ArthroCare	11.24			x		x	
21.	Aspen Technology	11.76	x	x		x	x	
22.	Asyst Technologies	NA		x		x	x	
23.	Atmel	8.55		x	x	x	x	
24.	Autodesk	33.40		x	x	x	x	
25	Barnes & Noble	73.32		x	x		x	
26.	BEA Systems	NA					x	
27	Bed, Bath & Beyond	88.74		x	x	x	x	
28.	Biomet	3.27		x				
29	Black Box	35.07		x	x			
30.	Blue Coat Systems	NA		x	x	x	x	
31.	Boston Communications Group	5.91			x	x	x	x
32.	Broadcom	120.20	x		x	x	x	x
33.	Brocade Communications Systems	119.78	x	x	x	x	x	x
34.	Brooks Automation	2.63	x	x	x	x	x	x
35.	CA	340.66		x		x	x	
36.	Cablevision	NA		x	x	x	x	
37.	Cardinal Health	87.05		x				
38.	Caremark Rx	88.98		x	x			
39.	CEC Entertainment	16.61			x	x	x	
40.	Ceradyne	0.37		x	x	x	x	
41	Children's Place	4.32					x	
42.	Chordiant Software	NA		x			x	
43.	Cirrus Logic	4.04		x	x		x	
44.	Cisco Systems	677.03		x				
45	Citrix	87.33					x	
46.	Clorox	60.54		x		x		
47.	CNET Networks	NA		x	x	x	x	x
48.	Coherent Inc.	8.06			x		x	
49.	Computer Sciences	46.97		x	x		x	
50.	Comverse Technology	208.80	x	x	x	x	x	x
51.	Corinthian Colleges	16.10		x	x		x	
52.	Costco	51.82				x	x	
53.	Crown Castle International	NA		x	x		x	
54.	Cyberonics	12.16		x	x	x	x	x
55	Dean Foods	19.88		x	x			

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Table 2 (continued)

	Company	Value of In-The-Money Options[1]	Lawsuits: Class Action[1]	Lawsuits: Derivative[1]	Disclosures: SEC or DOJ Investigation[1]	Disclosures: Restatement or Charges[1]	Disclosures: Internal Investigation[1]	Disclosures: Executive Departure[1]
56	Delta Petroleum	NA		x	x		x	
57	Digital River	NA		x	x	x	x	
58	Ditech Networks	$ 0.86		x			x	
59	Dot Hill Systems	NA					x	
60	Electronic Arts	94.00		x	x		x	
61	Electronics for Imaging	NA		x	x	x	x	
62	Embarcadero Technologies	NA				x	x	x
63	Emcore	NA		x		x	x	
64	Endocare	NA			x		x	
65	Engineered Support Systems[2]	NA			x			
66	EPIX Pharmaceuticals	NA					x	
67	EPlus	NA				x	x	
68	Equinix	NA		x	x		x	
69	Exar	20.42					x	
70	Extreme Networks	51.08			x		x	
71	F5 Networks	1.13		x			x	
72	Family Dollar	14.53		x	x		x	
73	Finisar	NA				x	x	
74	First American	7.53		x		x	x	
75	Forrester Research	NA					x	
76	Fossil	7.65		x		x	x	
77	Foundry Networks	NA		x	x	x	x	
78	GAP	444.47					x	
79	Getty Images	NA			x		x	
80	GlenAyre	NA		x			x	
81	Hansen Natural	0.76	x	x				
82	HealthSouth	136.09						
83	HCC Insurance Holdings	11.00			x	x	x	x
84	Home Depot	44.79		x	x	x	x	
85	Hot Topic	11.82		x				
86	Hovnanian Enterprises	NA		x				
87	i2 Technologies	NA				x	x	
88	iBasis	NA			x	x	x	x
89	Insight Enterprises	12.93		x	x		x	
90	Integrated Silicon Solution	NA		x		x	x	
91	Intuit	52.46			x		x	
92	J2 Global	NA				x	x	
93	Jabil Circuit	56.19	x	x	x		x	
94	Juniper Networks	154.82	x	x	x	x	x	
95	Jupitermedia	NA		x			x	
96	KB Home	32.48		x	x		x	x
97	Keithley	17.11		x			x	
98	King Pharmaceuticals	6.43				x	x	
99	KLA-Tencor	186.29	x	x	x	x	x	x
100	Knoblas	NA				x		
101	Kopin	27.85		x			x	
102	KOS Pharmaceuticals	NA			x	x	x	
103	K-V Pharmaceutical Company	NA		x			x	
104	L-3 Communications Holdings	117.63		x			x	
105	Linear Technology	107.35		x	x		x	
106	Macrovision	13.83			x		x	
107	Management Network Group	NA				x	x	
108	Marvell Technology Group	NA	x	x	x	x	x	
109	Mattel	35.07		x		x	x	
110	Maxim Integrated Products	184.75		x	x		x	

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Table 2 (continued)

Company	Value of In-The-Money Options[1]	Lawsuits: Class Action[2]	Lawsuits: Derivative[2]	Disclosures: SEC or DOJ Investigation[3]	Disclosures: Restatement or Charges[3]	Disclosures: Internal Investigation[3]	Disclosures: Executive Departure[3]
111. McAfee Inc.	$ 88.48		x	x	x	x	x
112. Meade Instruments	3.34	x	x	x		x	
113. Medarex	NA		x	x	x	x	x
114. Mercury Interactive	95.47	x	x	x	x	x	x
115. Michaels Stores	21.35	x	x	x		x	
116. Micrel	NA				x	x	
117. Microsoft	334.93						
118. Microtune	NA		x		x	x	
119. Mips Technologies	20.08		x	x	x	x	
120. Moldflow	NA				x	x	
121. Molex	14.15			x		x	
122. Monster Worldwide	79.77		x	x	x	x	x
123. msystems	NA		x	x	x	x	
124. Nabi	NA					x	
125. Nabors	230.06			x		x	
126. Nephros	NA				x	x	
127. Network Appliance	233.21		x			x	
128. Newpark Resources	NA					x	
129. Novell	13.62		x			x	
130. Novellus Systems	18.61		x			x	
131. Nvidia	104.67		x		x	x	
132. Nyfix	11.82		x	x	x		
133. O.I. Corporation	NA					x	x
134. Openwave Systems	35.38		x			x	
135. Parametric	11.56					x	
136. Par Pharmaceutical	0.00		x				
137. Pediatrix	30.49			x	x	x	x
138. Peet's Coffee	0.87		x			x	
139. Pixar	NA			x		x	
140. PMC-Sierra	136.91		x	x		x	
141. Pool Corp	9.25					x	
142. Power Integrations	11.03		x	x	x	x	
143. Progress Software	22.59		x	x	x	x	
144. Quest Software	NA		x	x	x	x	
145. QuickLogic	NA		x	x		x	
146. Rambus	16.86				x	x	
147. Redback Networks	37.32			x	x	x	
148. Renal Care	28.36			x			
149. Research In Motion	NA			x	x	x	
150. Restoration Hardware	NA				x	x	
151. RSA Security	34.53		x	x			
152. Safenet	NA		x	x	x	x	
153. Sanmina-SCI	122.18		x	x	x	x	x
154. Sapient	29.57				x	x	
155. SBA Communications	NA				x	x	
156. ScanSource	NA					x	
157. Selectica	NA					x	
158. Semtech	98.04		x	x	x	x	
159. Sepracor	124.06		x	x	x	x	
160. Sharper Image	NA				x	x	
161. Shaw Group	9.73				x	x	
162. Sigma Designs	NA		x	x		x	
163. Silicon Image	NA			x		x	
164. Silicon Storage Technology	NA		x				
165. Sonus Networks	NA				x	x	

014

Table 2 (continued)

Company	Value of In-The-Money Options[2]	Lawsuits: Class Action[3]	Lawsuits: Derivative[4]	Disclosures: SEC or DOJ Investigation[5]	Disclosures: Restatement or Charges[6]	Disclosures: Internal Investigation[7]	Disclosures: Executive Departure[8]
166. Stolt-Nielsen	NA			x	x		
167. SPSS	$ 18.00				x	x	
168. SteelCloud	NA					x	x
169. Sunrise Senior Living	8.97			x	x	x	
170. Sunrise Telecom	NA			x	x	x	
171. Sun-Times Media	NA				x	x	
172. Sycamore Networks	NA		x	x	x	x	
173. [illegible] Technology	NA						
174. Take-Two Interactive Software	6.43		x	x	x	x	
175. TETRA Technologies	3.18		x		x	x	
176. The Cheesecake Factory	15.31		x	x	x	x	
177. Third Wave	NA				x	x	
178. THQ	21.30		x	x		x	
179. Transaction Systems	1.89				x	x	
180. Trident Microsystems	2.93		x	x	x	x	x
181. Tyco	124.79				x	x	
182. Tyson Foods	2.31		x				
183. Ulticom	NA		x	x	x	x	
184. UnitedHealth	369.83	x	x	x	x	x	x
185. Valeant Pharmaceuticals	15.09		x	x	x	x	
186. [illegible]	NA			x		x	
187. VeriSign	NA		x	x		x	
188. ViaSat	4.93				x	x	
189. Vitesse Semiconductor	97.94	x	x	x	x	x	x
190. Waste Connections, Inc.	10.48		x				
191. Western Digital	6.40		x			x	
192. Westwood One	45.54		x				
193. Wet Seal	7.68				x	x	
194. Wind River	20.83					x	
195. Witness Systems	NA	x	x	x	x	x	x
196. Xilinx	195.04		x	x[10]	x	x	
197. [illegible]	NA				x	x	
198. Zoran	NA	x	x	x		x	

Notes and Sources:

1 The universe of companies is defined as those identified by the Wall Street Journal's Options Scorecard, Reuters Factbox and news searches as of 2/10/07.

2 In millions of dollars. Defined as the average value of fiscal year-end in-the-money exercisable and unexercisable options from 1997 through 2002. Data are from S&P's ExecuComp Database. NA means the data is not available in the database.

3 Data are from class action complaint documents as of 2/8/07.

4 Data are from news searches and SEC filings as of 2/10/07.

5 Defined as a formal or informal request for information or investigation from the SEC, or a subpoena from the US Attorney's Office

6 Defined as a company announcement of an actual restatement or charge, or the possibility of a restatement or charge.

7 Defined as a company announcement of an internal investigation relating to the accounting for or grant of stock options.

8 Defined as the resignation or termination of an executive officer or director due to an investigation into the backdating of stock options.

9 Acquired on 01/31/06 by DRS Technologies, Inc.

10 Indicates that the SEC or DoJ investigation has been concluded with no punitive action

11 Acquired on 11/19/06 by SanDisk Corp

12 Acquired on 05/05/06 by Walt Disney Co.

13 Acquired on 03/31/06 by Fresenius Medical Care AG & Co.

Although the data found in the above table have been produced and processed from sources believed to be reliable, no warranty, expressed or implied, is made regarding accuracy, adequacy, completeness, legality, reliability, or usefulness of any information.

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A:4

THE HONORABLE ROBERT S. LASNIK

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

In re F5 NETWORKS, INC. DERIVATIVE LITIGATION.	**Master File No. C06-0794 RSL** **NOMINAL DEFENDANT F5 NETWORKS, INC.'S MOTION TO DISMISS FOR FAILURE TO MAKE DEMAND** **NOTE FOR MOTION CALENDAR: APRIL 18, 2007** **ORAL ARGUMENT REQUESTED**

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I. SUMMARY

Nominal defendant F5 Networks, Inc. respectfully submits this motion to dismiss the Consolidated Verified Shareholders Derivative Complaint (the "Complaint"), based on Plaintiffs' failure to make demand on F5's Board of Directors prior to commencing this action.

This case is part of the sparse but expanding jurisprudence regarding the impact of so-called "backdating" of stock option grants. The "backdating" label is a loaded one that has been seized upon by would-be derivative plaintiffs to describe the granting of "in the money" stock options (*i.e.*, options for which the exercise, or "strike," price is lower than market value). As this Court has previously recognized, there is nothing inherently wrong with a company granting its executives or employees "in the money" options — the issue is whether those options have been properly accounted for, and whether the company's options practices have been adequately disclosed to the public. (And an "in the money" option does not mean that the grantee can exercise the option for an instant profit, because the option may not vest for years and the stock price could go down.) Thus, Plaintiffs' references to "illicit compensation" and "enrichment schemes" are worse than hyperbole; such statements fundamentally mischaracterize the nature of these "backdating" cases and the issues that properly underlie any analysis of potential liability.

The critical backdrop to this derivative case is that Plaintiffs purport to be acting on behalf of, and for the benefit of, F5 Networks, Inc. As with all derivative cases, this case implicates a core issue of corporate governance: as between the corporation's Board of Directors, and a handful of shareholders, who should be authorized to make litigation decisions on behalf of the company? Plaintiffs would have this Court disregard the strong legal presumption that the F5 Board will exercise its business judgment properly and in good faith, and instead defer to the judgment (and attendant motivations) of the Plaintiffs. But to preserve the strong presumption that litigation decisions (like all corporate decisions) should be made by the Board of Directors, the law requires a shareholder to make demand on the Board to pursue the claims at issue before the shareholder is authorized to proceed derivatively on the company's behalf. Because Plaintiffs in this case failed to make demand on F5's Board prior to commencing this action, Plaintiffs may proceed derivatively on F5's behalf only if they plead specific, particularized facts, on a director-by-director basis, that demand would have been "futile," because (1) a majority of the Directors were legally incapable of making litigation decisions for the company because they were interested or lacked independence, or (2) a particular challenged transaction was not a proper exercise of the Board's business judgment. *See In re Cray Inc. Deriv. Litig.*, 431 F. Supp. 2d 1114, 1121 (W.D. Wash. 2006).[1] This standard is an extremely high hurdle, which Plaintiffs do not, and cannot, clear.

In the Complaint, Plaintiffs identify 12 option grants (each to a different set of recipients) that are allegedly suspect. Plaintiffs' conclusion that improper "backdating" occurred is pure conjecture, based entirely on the fact that the grants at issue fell on or near monthly low points in F5's stock price. Plaintiffs devote over twenty pages of the Complaint to graphing and describing how the strike prices for the various grants relate to F5's stock price before and after the grant dates. But Plaintiffs' focus on the option grants themselves misses the mark: again, there is nothing improper about a company granting "in the money" options. As discussed below, the relevant issue is whether the option grants were properly accounted for and disclosed. Even if Plaintiffs could justifiably challenge the underlying option grants, for each grant transaction Plaintiffs must plead particularized facts showing that a majority of F5's Directors either lacked independence, or were "interested" in the specific grant such that they were incapable of impartially evaluating a challenge to that grant. Plaintiffs have alleged no such particularized facts, relying instead on generalized assertions that the Directors "participated in" the alleged "backdating scheme," and would never vote "to sue themselves." The law, including very recent authority from this Court, makes clear that such unsupported, conclusory allegations are inadequate to excuse demand. *See Cray*, 431 F. Supp. 2d at 1122. Alternatively, in order to demonstrate that demand was futile with regard to the option

[1] The *Cray* decision provides a very thorough and instructive template for many of the issues underlying this Motion.

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grant transactions, Plaintiffs must plead particularized facts showing that the grant was not a valid exercise of F5's Board's (or Compensation Committee's) business judgment. As discussed further in the Analysis section below, Plaintiffs have failed to plead a single specific fact that would permit such a finding.

Correctly analyzed, the gravamen of Plaintiffs' Complaint is that F5 allegedly (1) failed to properly account for the stock options at issue, and (2) failed to adequately disclose its stock option practices to the public. For the purposes of evaluating demand futility, therefore, the central question is whether a majority of F5's Directors in place at the time this lawsuit was commenced were either too "interested," or lacked sufficient independence, to evaluate properly whether F5 should commence litigation based on the alleged accounting and disclosure deficiencies.

The Complaint lacks the particularized facts necessary to demonstrate that demand on F5's Board would have been futile. As an initial matter, Plaintiffs have made no allegations whatsoever that F5's Directors lacked independence, *i.e.*, that they were so "beholden" to, or controlled by, F5's management or other directors that they were completely incapable of exercising independent judgment. Consequently, the only remaining issue is whether a majority of the Directors was sufficiently "interested" in the events at issue to disqualify those Directors from exercising their business judgment. The Complaint is devoid of particularized or individualized facts regarding the Directors' involvement in, knowledge of, or responsibility for F5's accounting treatment of the option grants at issue or F5's disclosures of its options practices. Again, and as discussed in detail below, Plaintiffs' demand futility allegations amount to nothing more than generic and conclusory assertions that the Directors "participated in" the alleged wrongdoing and would be unwilling to sue themselves or expose themselves to liability. Such generalized allegations regarding the threat of liability to Directors are inadequate, as a matter of law, to excuse demand. *See Cray*, 431 F. Supp. 2d at 1122.

It is also ultimately unnecessary to analyze whether a majority of the Directors was sufficiently disinterested to impartially evaluate whether to "sue themselves," because there was a

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standing Special Committee of the Board — made up of independent, disinterested, non-management directors — who could have considered Plaintiffs' demand. Indeed, that Special Committee thoroughly investigated the very issues of which Plaintiffs now complain and recommended significant remedial measures that F5 adopted in full.

The Complaint should be dismissed in its entirety, with prejudice, because Plaintiffs have failed to establish any right to usurp the role of F5's Board and proceed on the Company's behalf.

II. RELEVANT FACTS

A. The F5 Independent Investigation.

F5 Networks, Inc. is a Washington corporation, headquartered in Seattle, that provides networking products to improve the performance and security of network applications. Complaint ¶ 25. On May 22, 2006, F5 issued a press release disclosing that F5 had received a grand jury subpoena from the United States District Court for the Eastern District of New York requesting documents and information related to F5's granting of stock options since 1995. *See* Declaration of Stellman Keehnel ("Keehnel Dec."), Ex. A at p. 5.[2] The press release also stated that the SEC had commenced an informal inquiry and had requested documents and information regarding F5's options practices since 1997. *Id.*; Complaint ¶ 143. Finally, the May 22, 2006 press release disclosed as follows:

> F5's Board of Directors has authorized a review of the company's stock option grants. This review will be conducted with the assistance of outside independent legal counsel. The retention of independent accounting experts for this purpose has also been authorized by the Board.

Id. Thus, over two weeks before they commenced this litigation (*i.e.*, on June 8, 2006; *see* Complaint ¶ 152), Plaintiffs had notice that F5's Board — consisting of the same Directors that

---

[2] For the purposes of this dismissal motion, the Court may take judicial notice of all publicly-available information, including press releases and documents filed with the SEC. *In re Boeing Sec. Litig.*, 40 F. Supp. 2d 1160, 1165 (W.D. Wash. 1998) (courts may take judicial notice of SEC filings and other publicly-available information). And the Court may also consider any documents referenced in Plaintiffs' Complaint. *See, e.g., Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1295-96 (9th Cir. 1998); *In re Stac Elecs. Sec. Litig.*, 89 F.3d 1399, 1405 n.4 (9th Cir. 1996).

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Plaintiffs now challenge as unable to exercise their business judgment — had launched an independent investigation into the very stock option practices of which Plaintiffs complain.

In fact, on its own initiative, F5's Board did more than simply launch an independent investigation. On May 22, 2006, the Board also created a new Special Committee specifically for the purposes of conducting that investigation. *See* 2005 10-K/A2 (Keehnel Dec., Ex. B at p. 8). And the Board authorized the appointment of a new outside Director to serve on the Special Committee. That new Director, Deborah Bevier, joined F5's Board effective July 14, 2006. *See* July 20, 2006 Press Release (Keehnel Dec., Ex. C at p. 12). As of that date, Ms. Bevier and existing F5 Director Gary Ames constituted the Special Committee and oversaw all aspects of the independent investigation. 2005 10-K/A2 (Keehnel Dec., Ex. B at p. 8).[3] Thus, only a month after Plaintiffs commenced this derivative litigation, F5's Board had in place a committee of clearly disinterested directors to investigate the same practices that Plaintiffs now seek to challenge.

On October 25, 2006, F5 issued a press release announcing that the independent investigation launched by the Board was substantially complete. Keehnel Dec., Ex. D at p. 17; Complaint ¶ 5. The press release disclosed that, according to the results of the Special Committee's investigation, the dates used for certain stock option grants should not be relied upon for accounting purposes, and the Company would likely be required to restate its financials. *Id.* On the day following this announcement, F5's stock price rose by over 14.5% (from $58.12 to $66.63), and climbed by as much as 15.5% (to $67.17) in the following ten-day trading period. *See* Historical F5 Stock Price Chart (Keehnel Dec., Ex. E at p. 21).[4]

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[3] Mr. Ames is one of the F5 Directors who Plaintiffs concede never granted or received any allegedly "backdated" options. Complaint ¶ 152.

[4] "[M]any circuits hold that taking judicial notice of well-publicized stock prices and general market trends is permissible in a motion to dismiss." *In re Avista Corp. Sec. Litig.*, 415 F. Supp. 2d 1214, 1218 (E.D. Wash. 2005).

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On November 8, 2006, F5 issued another press release announcing the completion of the Board's independent investigation. Keehnel Dec., Ex. F at pp. 22-28; Complaint ¶ 6. The press release confirmed the Special Committee's conclusion that certain measurement dates related to F5 option grants should not be relied upon for accounting purposes, and that the Company would be required to restate its financials to recognize an additional stock-based compensation expense of approximately $22.9 million, in the aggregate, for fiscal years 1999 through 2006. *Id.* The press release also announced F5's Board's unanimous implementation of the following remedial measures:

- A "best practices" review and evaluation of the company's equity compensation controls, processes and procedures;
- A "best practices" review and evaluation of the company's controls, processes and procedures for documentation of corporate actions, including the drafting and finalizing of minutes, unanimous written consents and other similar corporate documentation;
- The adoption of a policy requiring that all equity compensation awards to board members, officers and employees be granted and priced according to a predetermined schedule; and
- The implementation of a cross-functional training program for certain key employees concerning (i) the company's equity compensation programs and related improvements to equity compensation controls, processes and procedures; (ii) the accounting implications of the company's equity compensation programs; and (iii) the legal implications of the company's equity compensation programs.

Id. In addition to the above corrective measures, F5 also announced that its General Counsel resigned and was replaced. Keehnel Dec., Ex. F at pp. 22-28; Complaint ¶ 7. On the day following this announcement, F5's stock closed up over 4% (rising from $65.49 to $68.33), and had climbed by over 13% (to $74.18) ten trading days later.

The independent forensic investigation commissioned by F5's Board of Directors (before this lawsuit was even commenced) was extremely thorough, spanning over five months, from May 22, 2006 through November 8, 2006. The Special Committee retained experienced independent legal counsel and reputable Big Four independent accountants to assist in the investigation. 2005 10-K/A2 (Keehnel Dec., Ex. B at p. 8). Just through September 2006, the expenses associated with the independent investigation exceeded ***$7 million***. *Id.*; Complaint ¶ 7. It

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cannot genuinely be argued that the Board's investigation of F5's stock option practices was, in any sense, a whitewash. F5's Board (again, the same Directors whose impartiality and integrity are being questioned by Plaintiffs) have, from the beginning, responded to these options issues seriously and appropriately.

B. <u>Plaintiffs' Derivative Claims</u>.

Plaintiffs filed suit on June 8, 2006. Complaint ¶ 152. The Complaint names 17 individual defendants comprising current and former F5 directors and officers. But the only defendants who are relevant for the purposes of this Motion are the six F5 Directors who were in place on June 8, 2006, *i.e.*, the Directors on whom Plaintiffs would have made demand had they proceeded properly before commencing this derivative litigation. The relevant defendant Directors for demand futility purposes are John McAdam, Alan Higginson, Karl Guelich, Keith Grinstein, Rich Malone, and Gary Ames (the "Director Defendants"). Complaint ¶ 152. McAdam is F5's Chief Executive Officer, but the remaining Director Defendants are all true "outside" directors, never having held an employment position with F5. Complaint ¶¶ 28-32.

In the Complaint, Plaintiffs assert 12 causes of action, under both federal and state law, but all of Plaintiffs' claims are predicated on three general categories of alleged wrongdoing: (1) allegedly "backdated" stock option grants; (2) allegedly misleading statements in F5's Proxy Statements; and (3) alleged violations of GAAP and SEC regulations that rendered F5's Forms 10-K false or misleading. These categories of alleged malfeasance are critical for the purposes of this Motion because they constitute the acts or omissions that Plaintiffs seek to challenge through this derivative action, and related to which any demand on the Director Defendants would, according to Plaintiffs, have been futile. In other words, these are the specific acts and omissions against which the Director Defendants' interest and independence must be measured.

<u>"Backdated" Grants</u>. Plaintiffs identify 12 stock option grants (occurring between October 1, 1999 and April 30, 2004) that Plaintiffs contend must have been "backdated." Complaint ¶ 9. Plaintiffs attempt to lend substance to their conspiracy theories by breaking out grant

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recipients who all received options in the same grant, thereby making it initially appear that more grants are at issue. *See* Complaint ¶ 9 (allegations regarding January 1, 2001 grant). Each of the challenged grants involved a different set of recipients; in some of the grants certain Director Defendants received options, and in other grants no Director Defendants received options. *See* Complaint ¶ 9 (allegations regarding October 1, 1999 and February 10, 2000 grants). Plaintiffs' **only** basis for claiming that the 12 referenced grants were deliberately "backdated" is that the grant strike prices fell on or near the low point of F5's stock price during the month of the grant. Complaint ¶¶ 62-73. Conspicuously absent from the Complaint are ***any*** allegations whatsoever regarding the authority pursuant to which each challenged grant was approved, how each grant was approved, or which of the Director Defendants, if any, participated in approving each grant.

Proxy Statements. Plaintiffs contend that F5's alleged options "backdating" activities rendered certain disclosures in F5's Proxy Statements false or misleading. Plaintiffs refer to seven Proxy Statements for the years 2000 through 2006. Complaint ¶¶ 78-107. From those Proxy Statements, Plaintiffs identify five categories of statements that were allegedly "knowingly false and misleading": **(i)** statements that outside directors automatically received options "with an exercise price equal to the fair market value of the Common Stock on the date of the grant" (Complaint ¶¶ 80, 84, 87, 90); **(ii)** statements that incentive stock options ("ISOs") for employees were "typically granted at the current market price" (Complaint ¶¶ 81, 88, 91, 95, 100); **(iii)** statements that, for ISOs, "the exercise price cannot be less than 100% of the fair market value of the Company's Common Stock on the date of the grant" (Complaint ¶¶ 82, 85, 92, 96, 101); **(iv)** statements that, beginning in 2001, outside directors who serve on Board committees will receive options with "an exercise price equal to the closing price of the Company stock on the grant date" (Complaint ¶¶ 84, 87, 90, 94, 99, 104); and **(v)** statements that options granted to employees under the 2000 stock plan, and options related to the uRoam Acquisition, "will have an exercise price of not less than the fair market value of the Company's stock on the date the option is granted" (Complaint ¶¶ 97, 102, 106).

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Violations of GAAP and SEC Regulations. Finally, Plaintiffs contend that F5 failed to properly account for certain stock option grants, which allegedly resulted in violations of Generally Accepted Accounting Principles ("GAAP") and SEC regulations related to disclosure of executive compensation. Complaint ¶¶ 112-125. Plaintiffs assert that these alleged violations rendered F5's Forms 10-K for the years 1999 through 2005 false and misleading, because those 10-Ks incorporated F5's financial statements. Complaint ¶¶ 127-133.

As discussed below, regardless of whether there is any merit to the claims that Plaintiffs seek to assert based on the above-referenced alleged acts and omissions, those claims do not belong to Plaintiffs, and Plaintiffs have no right or authority to advance them. The Complaint patently lacks sufficient particularity to establish that the Director Defendants are interested in the alleged acts and omissions (or that they lack independence), such that a demand on F5's Board related to those acts and omissions would have been futile. Therefore, there is no basis for the Court to substitute Plaintiffs' judgment for the sound business judgment of the Board.

III. AUTHORITY AND ANALYSIS

A. Plaintiffs Bear An Extremely Heavy Burden To Establish Demand Futility.

A shareholder who wishes to proceed with a derivative action must comply with Rule 23.1, which states: "The complaint shall also allege ***with particularity*** the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority ... and the reasons for the plaintiff's failure to obtain the action or for not making the effort." Fed. R. Civ. P. 23.1 (emphasis added). This procedural demand requirement is intertwined with the ***substantive*** requirement (developed primarily through case law) that a shareholder may not proceed derivatively without first making demand on the Board, unless demand is excused. *See Kamen v. Kemper Fin. Servs.*, 500 U.S. 90, 96 (1991).

Fundamentally, "the decision to bring a lawsuit or to refrain from litigating a claim on behalf of the corporation is a decision concerning the management of the corporation and consequently is ***the responsibility of the directors***." *Blasband v. Rales*, 971 F.2d 1034, 1047 (3d Cir. 1992) (citing

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Levine v. Smith, 591 A.2d 194, 200 (Del. 1991)) (emphasis added). A board's decision regarding whether to pursue litigation is entitled to the protection of the Business Judgment Rule, which creates a presumption that directors properly inform themselves and make sound business judgments. *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 990 (9th Cir. 1999). Plaintiffs must overcome this fundamental presumption in order to proceed with this action.

Where (as here) a plaintiff seeks to proceed derivatively on behalf of a corporation without first making demand on the corporation's Board, the plaintiff bears the heavy burden of pleading with factual particularity that demand would have been "futile." *Aronson v. Lewis*, 473 A.2d 805, 809 (Del. 1984). This standard is more than a technical pleading requirement, "it is a rule of substantive right designed to give a corporation the opportunity to rectify an alleged wrong without litigation, and to control any litigation which does arise." *Aronson*, 473 A.2d at 809. In determining whether Plaintiffs have met this substantive standard, "conclusory allegations of fact or law not supported by allegations of specific fact may not be taken as true." *Levine*, 591 A.2d at 207 (internal citation omitted). Plaintiffs must instead plead ***particularized*** facts — what the Delaware Supreme Court has referred to as being in the nature of "ultimate facts" or "elemental facts," *i.e.*, those specific facts that will actually sustain a claim — to establish why demand should be excused. *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000); *accord Cray*, 431 F. Supp. 2d at 1121. Importantly, this burden is "***more onerous than that required to withstand a Rule 12(b)(6) motion to dismiss***." *Levine*, 591 A.2d at 207 (emphasis added). In other words, even if one assumes Plaintiffs' claims have substantive merit (which F5 denies), they must nevertheless be dismissed if Plaintiffs fail to meet their "stringent requirements of factual particularity." *Brehm*, 746 A.2d at 254.

In *Aronson*, the Delaware Supreme Court created a two-pronged test for analyzing a claim of demand futility (a test that this Court adopted in *Cray*, 431 F. Supp. 2d at 1121). When a derivative plaintiff seeks to challenge a specific transaction or decision by a board of directors, demand is excused if, based on particularized facts, "a reasonable doubt is created that: (1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid

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exercise of business judgment." *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993) (citing *Aronson* and clarifying that the two *Aronson* prongs are independent of one another). Where a derivative plaintiff is not challenging a specific board action (*e.g.*, where a plaintiff claims the board improperly *failed* to act), the second prong of *Aronson* (the "business judgment" prong) is inapplicable. *Rales*, 634 A.2d at 933; *Cray*, 431 F. Supp. 2d at 1121 n.4. In those circumstances, the Court must "examine whether the board that would be addressing the demand can impartially consider its merits without being influenced by improper considerations," *i.e.*, whether the board is disinterested and independent (the first *Aronson* prong). *Rales*, 634 A.2d at 933-34; *Cray*, 431 F. Supp. 2d at 1121. As discussed below, if Plaintiffs here were permitted to challenge the specific F5 stock option grant transactions they reference in the Complaint, both prongs of the *Aronson* test would be implicated for analyzing demand futility. Conversely, because Plaintiffs' Proxy Statement and GAAP/SEC regulation allegations do not challenge any specific act of the Board (but are based instead on allegedly inadequate disclosure and accounting controls), only the first prong of *Aronson* (the "impartiality" prong) is relevant to those allegations.

B. <u>Plaintiffs Do Not Allege That Any Of The Director Defendants Lacks Independence.</u>

The first prong of the *Aronson* demand futility test, the "impartiality" prong, has two components. The first component (discussed at length in the following subsections) relates to whether a director is sufficiently "disinterested" to impartially consider a shareholder demand. The second component addresses whether a director is "independent." The issue of "independence" is effectively a stand-alone test because a lack of independence by a majority of the board may, in and of itself, excuse a derivative plaintiff from making demand. *Rales*, 634 A.2d at 936; *Cray*, 431 F. Supp. 2d at 1121 (majority of directors must be both independent <u>and</u> disinterested).

In the demand futility context, the concept of "independence" has a very specific meaning, relating to whether an otherwise disinterested director is so entirely under the influence of an interested director (or members of company management) that the disinterested director's "discretion would be sterilized." *Rales*, 634 A.2d at 936. "A controlled director is one who is dominated by

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another party, whether through close personal or familial relationship or through force of will." *Cray*, 431 F. Supp. 2d at 1127 (citing *Telxon Corp. v. Meyerson*, 802 A.2d 257, 264 (Del. 2002)). Thus, to establish a lack of independence, Plaintiffs must allege with the requisite particularity how and why each Director Defendant is "dominated" by some interested person.[5]

Plaintiffs have not alleged a single particularized fact that bears on the independence of any Director Defendant. The closest Plaintiffs come is to allege that the Director Defendants will not "sue themselves and/or their fellow directors and allies in the top ranks of the corporation for the violations of law complained herein. These are people they have developed professional relationships with, who are their friends and with whom they have entangling financial alliances, interests, and dependencies ...." Complaint ¶ 154(a). Plaintiffs also state summarily that "[c]ertain directors are also dominated and controlled by other directors and cannot act independently of them." Complaint ¶ 154(b). These allegations do not even approach the level of specificity required to plead demand futility. Which Director Defendants are "friends with" or "entangled with" which other Directors or F5 officers? Which Director Defendants are "dominated and controlled" by which other Directors? And, most importantly, what is the nature of these various relationships and "alliances" that would possibly render any Director Defendant incapable of exercising independent judgment and free will? The Complaint is silent on all counts.

Courts have uniformly held that general references to friendship, business relationships, or other affinity amongst directors is insufficient to negate independence. In *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004), the Delaware Supreme Court observed:

> [S]ome professional or personal friendships, which may border on or even exceed familial loyalty and closeness, may raise a reasonable doubt whether a director can appropriately consider demand. ... Not all friendships, or even most of them, rise to

[5] A director may also not be independent if his or her livelihood is dependent on the company (for example, where the director is also an employee). *Cray*, 431 F. Supp. 2d at 1127. The only Director Defendant conceivably implicated by that standard is McAdam, so it is irrelevant to this inquiry because a majority of the Directors must lack independence in order for demand to be excused.

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> this level and the Court cannot make a *reasonable* inference that a particular friendship does so without specific factual allegations to support such a conclusion.

Id. at 1050 (internal quotation omitted; emphasis in original). *Accord Aronson*, 473 A.2d at 816 ("The shorthand shibboleth of 'dominated and controlled directors' is insufficient"). In *Beam*, the plaintiff alleged that the directors "moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends' …," and those relatively particularized allegations were *still* deemed insufficient to rebut the presumption of director independence. 845 A.2d at 1051. Here, Plaintiffs provide not one iota of detail regarding the supposed personal "entanglement" of any of the Director Defendants — as such, Plaintiffs cannot establish that any of the Director Defendants lack the requisite independence.

Because Plaintiffs have failed to allege specific facts to rebut the presumption of the Director Defendants' independence on any issue, F5 will not again address the independence component of the *Aronson* test in this Motion. That component has no bearing on Plaintiffs' claim that demand on F5's Board would have been futile.

C. Plaintiffs Have Failed To Establish That Demand Was Futile Or Excused.

Regardless whether the Court applies the single-pronged *Rales* test or the two-pronged *Arneson* test to the Complaint, Plaintiffs' generic and conclusory allegations fail to establish that demand on the Director Defendants would have been futile. For each of the three categories of alleged wrongdoing on which Plaintiffs rely — (1) allegedly "backdated" stock option grants; (2) allegedly misleading statements in F5's Proxy Statements; and (3) alleged violations of GAAP and SEC regulations — Plaintiffs have failed to meet the stringent standards necessary for demand to be excused. The following subsections analyze, in turn, each of Plaintiffs' three categories of alleged wrongdoing.

1. Allegedly "Backdated" Option Grants.

There is a fundamental threshold question regarding whether Plaintiffs may challenge the mere fact that F5 granted "in the money" options (divorced from the accounting and disclosure

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implications of those grants). But even if Plaintiffs are permitted to challenge the allegedly suspect option grants they identify in the Complaint, Plaintiffs have failed to establish that demand with regard to those grants would have been futile.

a. <u>There Is Nothing Improper About Granting "In The Money" Options</u>.

In its Order remanding to state court two of the derivative actions filed against F5, this Court correctly observed as follows:

> Companies are allowed to compensate their executives by providing them with options to purchase stock at prices lower than market value. These are called "in the money" options. One form of such an option grant would be to give an executive the option to purchase stock in the company at a cost equal to the price of the stock at some arbitrary date in the past, such as a date during which the price of the stock was low. Like any other form of compensation, however, companies must record this option grant as compensation for the purpose of reports to shareholders, earnings reports to the SEC, and in tax forms. Thus, ***when plaintiff complains of the "backdating" of options, the alleged illicit practice is more thoroughly described as the granting of below-market options to purchase stock and the failure to report those options as compensation.***

Order Granting Plaintiffs' Motion To Remand [Docket No. 34] at 5:6-15 (emphasis added). The Court's observations go to the very heart of what is misleading, and often confusing, about Plaintiffs' Complaint and their claims of demand futility. Even if Plaintiffs' rank speculation, based on a narrow statistical review of stock and grant prices, that deliberate "backdating" of options occurred at F5 were entirely correct, it is nonsensical for Plaintiffs to be challenging the mere fact that "in the money" options were granted, because the Board or Compensation Committee could have chosen, at any time, to grant such options. Any cognizable damage to the Company, and therefore <u>all</u> of Plaintiffs' proposed derivative claims, spring (if at all) not from the fact that "in the money" options were granted, but from the alleged failure to properly account for those grants or to adequately disclose F5's grant practices. Stated differently, if F5 had properly expensed every "in the money" grant as compensation, and had clearly disclosed in its Proxy Statements that the Company periodically awarded grants priced below fair market value, the Complaint would never have been filed.

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Plaintiffs may argue that granting "in the money" options was inherently improper because the F5 Stock Option Plans purportedly prohibited that practice. *See* Complaint ¶ 75. But the 1998 Plan authorizes "in the money" grants of Nonstatutory Stock Options. *See* 1998 Stock Option Plan § 6.[6] And the Board had absolute discretion to amend the Stock Option Plans at any time. For example, the 1996 Plan granted the Board

> sole authority, ***in its absolute discretion***, to: (a) construe and interpret this Plan; (b) define the terms used in this Plan; (c) ***prescribe, amend and rescind rules and regulations relating to this Plan***; (d) correct any defect, supply any omission or reconcile any inconsistency in this Plan; (e) determine the individuals to whom Options shall be granted under this Plan and whether the Option is an Incentive Stock Option or a Non-Qualified Stock Option; (f) ***determine the time or times at which Options shall be granted under this Plan***; (g) determine the number of shares of Common Stock subject to each Option, ***the exercise price of each Option***, the duration of each Option and the times at which each Option shall become exercisable; (h) ***determine all other terms and conditions of Options***; and (i) make all other determinations necessary or advisable for the administration of this Plan. ***All decisions, determinations and interpretations made by the [Board] shall be binding and conclusive on all participants in this Plan and on their legal representatives, heirs and beneficiaries.***

1996 Stock Option Plan § 2 (emphasis added). Thus, even assuming that some provision of the Plan theoretically prohibited the grant of "in the money" options, the Board could simply have amended the Plan at the same time the Board approved the option grant, and Plaintiffs would have had no recourse whatsoever. Again, as this Court noted, the issue is ***not*** whether the grant of an "in the money" option is improper; the issue is whether the Company properly accounted for "in the money" options and adequately disclosed its actual options practices.

While these distinctions appear theoretical, they have real implications for this Motion and for Plaintiffs' bid to proceed derivatively on F5's behalf. If the "challenged transactions" to which Plaintiffs' demand would have applied are the stock grants themselves, it creates a separate set of

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[6] The four Stock Option Plans referenced in the Complaint (¶ 51) are attached as Exhibits H through K at pp. 35-80 to the Keehnel Declaration for the Court's general reference. Each of the Plans contains similar language granting the Board virtually unlimited discretion to interpret or amend the Plan at any time, within the Board's sole discretion.

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issues for evaluating the Director Defendants' disinterestedness and the propriety of the stock grants under the Business Judgment Rule. Ultimately the result is the same because, as discussed below, Plaintiffs' demand futility arguments still fail when applied to the stock grants. If, however, the Court recognizes the gravamen of the Complaint as disclosure and accounting issues, an extended analysis of the grants becomes unnecessary.

b. **Demand Was Not Futile Based On Director Interest In The Stock Grants.**

If the Court chooses to analyze demand futility related to the stock grant transactions themselves, the Court must determine whether the particularized factual allegations of the Complaint create a reasonable doubt that F5's Board could have properly exercised its "disinterested" business judgment in responding to Plaintiffs' demand. *Cray*, 431 F. Supp. 2d at 1121 (citing *Rales*). "A director is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders. Directorial interest also exists where a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders." *Rales*, 634 A.2d at 936 (internal citations omitted). Critically, however, "***the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge the disinterestedness of directors***. In other words, a plaintiff may not bootstrap allegations of futility by pleading merely that the directors participated in the challenged transaction or that they would be reluctant to sue themselves." *Cray*, 431 F. Supp. 2d at 1122 (internal quotations omitted; emphasis added) (citing *In re Sagent Tech., Inc., Deriv. Litig.*, 278 F. Supp. 2d 1079, 1089 (N.D. Cal. 2003)).

There are at least two threshold issues that bear on an analysis of the "disinterestedness" of F5's Directors related to the challenged stock grants. First, plaintiffs must demonstrate that at least four Director Defendants are interested with regard to each grant transaction. Demand is futile only if a majority of the Board is interested (and therefore incapable of an impartial evaluation of the demand). *Cray*, 431 F. Supp. 2d at 1121. As discussed above, ***prior*** to this derivative action being commenced, F5's Board had voted to form a Special Committee to commence an independent

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investigation into stock option issues, and to bring on a new Director to serve on that Special Committee. The new Director, Deborah Bevier, joined the Board effective July 14, 2006, only five weeks after Plaintiffs filed their initial lawsuit (and well before any of the derivative cases were consolidated or Plaintiffs and their counsel were appointed to lead this consolidated action). Given the novelty and complexity of these stock option issues, and the time required for a thorough investigation and deliberation, any demand made on F5's Board would have been ultimately evaluated by the six Director Defendants <u>and</u> Ms. Bevier, for a total of seven directors. Thus, for each stock grant transaction Plaintiffs wish to challenge, they must demonstrate that four of the Director Defendants (*i.e.*, a majority of the Board) were interested in that particular grant.

<u>Second</u>, it is critical to bear in mind that Plaintiffs' allegations regarding deliberate and secret "backdating" of options at F5 is based <u>entirely</u> on conjecture. Plaintiffs identify a subset of F5's option grants, note that those grants fell on or simply *near* the low point of F5's stock price during the month of the grant, and summarily conclude that intentional and "fraudulent" conduct *must have* occurred. Conspicuously missing from the Complaint are any allegations regarding the total number of option grants F5 made during the six-year period that Plaintiffs rely upon (1999-2005), how the strike prices of those other grants compared to F5's stock price before and after the grants, and how Plaintiffs' subset of hand-picked grants fits into the overall context of F5's stock option practices. *See In re Linear Tech. Corp. Deriv. Litig.*, No. C-06-3290 MMC, 2006 WL 3533024, *3 (N.D. Cal. Dec. 7, 2006) ("With respect to the allegations of 'backdating,' the only factual allegation offered by plaintiffs is that on seven occasions over a period of seven years, stock options were dated 'just after a sharp drop' in Linear's stock and 'just before a substantial rise,' which, plaintiffs allege, constitutes a 'striking pattern that could not have been the result of chance.' ***Because plaintiffs provide no facts as to how often and at what times the Committee Defendants have granted stock options in the past, no 'pattern,' let alone a 'striking' one, is apparent***") (internal citations omitted; emphasis added). Plaintiffs do not refer to a single piece of actual evidence that any Director Defendant knew that options were being "backdated," or sought to profit from such activity. In short, the predicate to

any challenge to the grant transactions — *i.e.*, that the options were intentionally "backdated" — is raw speculation, a fact that should inform the Court's consideration of F5's Board's capacity to impartially evaluate Plaintiffs' claims.

Against that backdrop, the question is whether a majority of F5's Directors was "interested" with regard to any particular option grant transaction identified in the Complaint. One way of demonstrating interest is to show that a Director "***will*** receive a personal financial benefit from a transaction that is not equally shared by the stockholders." *Rales*, 634 A.2d at 936 (emphasis added). Plaintiffs imply that the Director Defendants are interested because some of them received allegedly "backdated" options. *See* Complaint ¶¶ 152, 154(d). As an initial matter, there are only two grants challenged by Plaintiffs in which four of the Director Defendants received options: the January 1, 2001 grant and the May 6, 2002 grant (Complaint ¶ 8).[7] Thus, at most, the receipt of allegedly "backdated" options would relate only to those two grants. More importantly, the financial benefit, if any, from the grant transactions themselves has already been received by the Director Defendants — the issue now is whether the granting of the challenged options should somehow subject the Director Defendants to personal liability. Thus, the Directors' interest in the grant transactions is properly evaluated not on the basis of prospective benefit, but on the basis of whether Plaintiffs' demand "will have a materially detrimental impact on a director, but not on the corporation and the stockholders." *Rales*, 634 A.2d at 936.

Plaintiffs assert that this action will have a materially detrimental impact on the Director Defendants because they allegedly "played a central role in the events leading up to the backdating debacle that has ensnarled F5 and the Board members face a substantial likelihood of personal liability as a result of their actions and conscious failures to act." Complaint ¶ 153. It is beyond

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[7] It should be noted that in the Introduction section of the Complaint, Plaintiffs allege that Directors Higginson, Guelich, and Grinstein each received 100,000 options as part of the January 1, 2001 grant. Complaint ¶ 9. That allegation is erroneous, and Plaintiffs acknowledge later that, in fact, Directors Higginson, Guelich, and Grinstein received only 7,500 options apiece as part of the January 1, 2001 grant. Complaint ¶ 65.

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dispute that the mere threat of personal liability for approving or participating in the challenged transaction is ***not*** sufficient to overcome the presumption of director disinterestedness. *Cray*, 431 F. Supp. 2d at 1122; *Aronson*, 473 A.2d at 815. The potential for liability can only establish director interest "in ***rare cases*** [where] a transaction [is] so ***egregious on its face*** that board approval cannot meet the test of business judgment, and a ***substantial likelihood of director liability*** therefore exists." *Aronson*, 473 A.2d at 815 (emphasis added).

This is clearly not that "rare and egregious case" where director liability is substantially likely. Here, there is not even evidence that the challenged option grant transactions involved any wrongdoing of any kind — there is nothing more than Plaintiffs' sheer speculation that something nefarious *must have* occurred based on the fortuity of certain grant dates. More to the point, there are no allegations whatsoever in the Complaint regarding how each of the challenged grants was approved, pursuant to what authority, and (most importantly) by which Director Defendants. If a particular Director Defendant merely received an allegedly "backdated" option, but did not ***approve*** the granting of that option, there would be no basis for liability as to that Director (any more than there would be for a line employee who received such an option). For each grant transaction referenced in the Complaint, Plaintiffs bear the burden of pleading particularized facts demonstrating that a majority of F5's Board was interested ***as to that grant*** — that exercise obviously requires an assessment of each Director's individual interest or disinterestedness. But there are literally no facts in the Complaint that permit an analysis of any particular Director Defendant's participation in, or approval of, any particular grant. Without specific facts on that issue, Plaintiffs have failed to plead ***any*** likelihood, let alone substantial likelihood, of the Director's liability.

Indeed, Plaintiffs' burden of establishing a "substantial likelihood" of liability is made even more difficult by the fact that F5's Articles of Incorporation expressly limit the Directors' liability.[8]

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[8] F5's Articles of Incorporation are attached as Exhibit G at pp. 29-34 to the Keehnel Declaration. Because they are publicly-available through the Washington Secretary of State, the Court may take judicial notice of the Articles. *Boeing*, 40 F. Supp. 2d at 1165.

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F5's Articles provide, in relevant part, as follows: "No director of the Corporation shall be personally liable to the Corporation or its shareholders for monetary damages for his conduct as a director, except for (i) acts or omissions that involve intentional misconduct or a knowing violation of law by the director, ... or (iii) any transaction from which the director will personally receive a benefit in money, property or services to which the director is not legally entitled." Articles of Incorporation § 5.2. As discussed above, the exception for "personal benefit" applies, at most, to two of the challenged grants — January 1, 2001 and May 6, 2002 — because those are the only grants in which four of the Director Defendants allegedly received options. Even if the receipt of those two grants were sufficient to render a majority of the Board interested as to those grants, for all other grants Plaintiffs must prove that the Director Defendants ***intentionally*** "backdated" options or ***knowingly*** violated the law, *i.e.*, that the Directors committed fraud. As discussed, the Complaint lacks ***any*** facts, let alone particularized facts, that would support a finding of fraud as to any of the Director Defendants.

Similar to Plaintiffs' suggestion that the Director Defendants face a substantial likelihood of liability, Plaintiffs also suggest that the Director Defendants are interested because "[a]ny suit by the current directors of F5 to remedy these wrongs would likely further expose the liability of defendants under the federal securities laws, which could result in additional civil and/or criminal actions being filed against one or more of the defendants, thus, they are hopelessly conflicted in making any supposedly independent determination whether to sue themselves." As an initial matter, this is a curious assertion given that, ***before*** Plaintiffs commenced this action, (i) F5 had already launched its own internal investigation (which spanned over five months and cost in excess of $7 million), and (ii) F5 was already under investigation by both the Department of Justice and the SEC. 2005 10-K/A2 (Keehnel Dec., Ex. B at p. 8). And F5 consistently announced that it was producing information and cooperating fully with the Government's inquiries. *Id.* at 8. In short, since at least May 2006, it has been clear that all relevant facts related to F5's stock option practices would inevitably be exposed. Moreover, this Court has already recognized that bare allegations regarding

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possible "exposure" to further liability are inadequate to challenge director disinterestedness. *Cray*, 431 F. Supp. 2d at 1121 n.5.[9] *See also Seminaris v. Landa*, 662 A.2d 1350, 1354-55 (Del. Ch. 1995) (allegations that directors were named in pending securities class actions, and subjects of SEC investigation, insufficient to create reasonable doubt regarding director disinterestedness).

Finally, Plaintiffs allude to alleged "unlawful insider sales" by certain Director Defendants. *See* Complaint ¶¶ 137, 152 (and charts). It is not clear whether Plaintiffs are relying on those alleged sales to support their claim that F5's Board was incapable of acting impartially on Plaintiffs' demand. Plaintiffs do state in their demand futility allegations that the "members of F5's Board of Directors have benefited, and will continue to benefit, from the wrongdoing alleged herein ...," but do not specify whether that "benefit" is meant to include alleged "insider sales." To the extent Plaintiffs intend to rely on purportedly "unlawful insider sales" to rebut the Directors' disinterestedness, this Court has already considered and rejected that theory. In *Cray*, this Court analyzed the impact of insider sales and concluded that they were insufficient to establish interestedness. 431 F. Supp. 2d at 1126 (citing *Sagent* and *Guttman v. Huang*, 823 A.2d 492 (Del. Ch. 2003)). F5 will not repeat this Court's thorough analysis on this point, but respectfully directs the Court to the *Cray* opinion.[10]

In summary, Plaintiffs have failed to allege any particularized facts to establish that a majority of the Director Defendants are "interested" as to any of the option grant transactions that

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[9] The complaint in *Cray* contained cookie-cutter demand-futility allegations virtually identical to those asserted by Plaintiffs here. This Court was able to summarily reject the vast majority of those allegations as patently inadequate to meet the particularity requirements of the demand futility standard. *See Cray*, 431 F. Supp. 2d at 1121 n.5.

[10] It should be noted that *Cray* did suggest that the timing and magnitude of the insider trades in question could be relevant. That observation was in response to the plaintiffs' reliance on *Zimmerman v. Braddock*, No. Civ.A.18473-NC, 2005 WL 2266566 (Del. Ch. Sept. 8, 2005), in which three of the director defendants sold $248 million of stock in just 45 days. *See Cray*, 431 F. Supp. 2d at 1125-27. Here, the six Director Defendants allegedly sold an aggregate of $56,153,064 over a seven-year period (1999 to 2006), and $42.9 million of those sales were by a single Director (McAdam pursuant to a 10b5-1 prescheduled sales plan). Complaint ¶ 137. Moreover, there is <u>no</u> link in the Complaint between any of the alleged insider sales and any of the allegedly "backdated" options. Finally, there is no cause of action for common law "insider trading" in Washington, so those allegations should have no bearing on whether the Directors face a substantial likelihood of liability. *Cray*, 431 F. Supp. 2d at 1133.

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Plaintiffs challenge in the Complaint. As such, demand was not futile under the first prong (the "impartiality" prong) of the *Aronson* test.

c. **Demand Was Not Excused On The Grounds That The Stock Grants Were Not A Valid Exercise Of Business Judgment.**

Under the second prong of the *Aronson* test (the "business judgment" prong), Plaintiffs can establish that they were excused from making demand on the F5 Board if they plead particularized facts creating a reasonable doubt that the challenged option grants were "the product of a valid exercise of business judgment." *Rales*, 634 A.2d at 933 (citing *Aronson*, 473 A.2d at 814). Thus, this test requires Plaintiffs to plead a set of specific facts that, on their face, overcome the fundamental presumptions created by the Business Judgment Rule. "[The Business Judgment Rule] is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts." *Aronson*, 473 A.2d at 812.

To rebut the presumption of the Business Judgment Rule for demand futility purposes, it is not sufficient (or permissible) for a plaintiff to challenge the substantive merits of a Board decision, because that would simply invite shareholders to second-guess Board actions (the very evil the Business Judgment Rule is intended to prevent). *See, e.g., A.R. DeMarco Enters., Inc. v. Ocean Spray Cranberries, Inc.*, No. Civ. A. 19133-NC, 2002 WL 31820970, *5 (Del. Ch. Dec. 4, 2002) (rejecting demand futility challenge to Business Judgment Rule: "No facts are alleged which even suggest that the directors' actions were not in the best interest of the corporation except that plaintiff thinks they are not"). Nor is it sufficient for plaintiffs to allege merely that some form of wrongdoing, or harm to the company, occurred on the directors' watch. *See, e.g., Stone ex rel AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 371 (Del. 2006) (demand not excused, despite company paying $50 million in civil penalties based on legal violations committed during directors' tenure). A would-be derivative plaintiff must instead plead, with particularity, that the decision-

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making *process* was grossly negligent or otherwise conducted in bad faith. For example, in *Brehm* the Court observed: "As for the plaintiffs' contention that the directors failed to exercise 'substantive due care,' we should note that such a concept is foreign to the business judgment rule. Courts do not measure, weigh or quantify directors' judgments. We do not even decide if they are reasonable in this context. Due care in the decision-making context is *process* due care only." 746 A.2d at 264 (emphasis in original).[11]

In this case, Plaintiffs cannot possibly overcome the presumptions of the Business Judgment Rule. Plaintiffs have no way of attacking the due care involved in the ***process*** of granting the challenged stock options because the Complaint is devoid of any allegations regarding that process. As discussed above, Plaintiffs have not even alleged which (if any) of the Director Defendants participated in approving any particular option grant, let alone how the approval process was conducted grossly negligently or in bad faith. *Brehm*, 746 A.2d at 264. The Business Judgment Rule is one of the most fundamental and inviolable precepts of corporate law, and Plaintiffs bear an extremely heavy burden of pleading ultimate facts sufficient, on their face, to overcome the Rule. They have pled no such facts.

d. The Court Should Disregard The *Maxim* Decision.

On February 6, 2007, the Delaware Chancery Court (Chancellor Chandler) issued an order in the Maxim Integrated Products derivative litigation. *See Ryan v. Gifford*, No. Civ. A. 2213-N, 2007 WL 416162 (Del. Ch. Feb. 6, 2007) ("*Maxim*"). Plaintiffs will undoubtedly trumpet *Maxim* as the lodestar decision regarding the application of demand futility in the options "backdating" context. *Maxim* involved allegations of systematic, fraudulent "backdating" of stock options, and Chancellor Chandler concluded that those allegations were sufficient to excuse demand under both

[11] In *Brehm*, the Delaware Supreme Court also noted that "[i]t is the essence of business judgment for a board to determine if a particular individual warrants large amounts of money ...," and that "the size and structure of executive compensation are inherently matters of judgment." 746 A.2d at 263 (internal citations omitted). Thus, board decisions regarding compensation issues (like decisions to grant "in the money" options) are entitled to particular deference. *Id.*

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prongs of the *Aronson* test, the "impartiality" prong and the "business judgment" prong. The *Maxim* decision is neither determinative nor instructive here because the underlying facts are distinguishable, and because many of Chancellor Chandler's findings and rulings are simply erroneous.

There are a number of reasons the Court should disregard *Maxim*. First, and perhaps most importantly, the entire ruling is predicated on an <u>assumption</u> that fraud occurred. Indeed, the assumption of fraud is inherent in Chancellor Chandler's definition of "backdating": "Commonly known as backdating, this practice involves a company issuing stock options to an executive on one date while providing ***fraudulent*** documentation asserting that the options were actually issued earlier. These options may provide a windfall for executives because the ***falsely*** dated stock option grants often coincide with market lows." 2007 WL 416162 at *1 (emphasis added). This basic definition is the thread that runs through the remainder of the *Maxim* analysis; and this foundational assumption that "backdating" equates to fraud is (to mix metaphors) the first domino that tips over a series of rather remarkable holdings regarding the implications of granting "in the money" options. Based on the plaintiffs' bare assertion that the Maxim directors fraudulently "backdated" options — supported only by a third-party statistical analysis of Maxim's option grants (discussed further below) — Chancellor Chandler concluded that "[a] board's knowing and intentional decision to exceed the shareholders' grant of express (but limited) authority raises doubt regarding whether such decision is a valid exercise of business judgment and is sufficient to excuse a failure to make demand." *Id.* at *9. Chancellor Chandler then made the following statement (which is certain to appear, in bold, in every future "backdating" complaint):

> I am unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith. It certainly cannot be said to amount to faithful and devoted conduct of a loyal fiduciary. Well-pleaded allegations of such conduct are sufficient, in my opinion, to rebut the business judgment rule and to survive a motion to dismiss.

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Id. at *12. Thus, under *Maxim*, "backdating" (*as Chancellor Chandler defines it*) is apparently a *per se* breach of a director's fiduciary duties.

If one starts from the premise that "deliberate" conduct "intended to mislead shareholders" occurred, it is not difficult to end up where Chancellor Chandler did. But the *Maxim* rulings are based on a critical and fundamental misconception: that granting an "in the money" option ***must*** involve a "lie" or a knowing violation of the law. Chancellor Chandler stated:

> Yet, it is difficult to understand how a plaintiff can allege that directors backdated options without simultaneously alleging that such directors knew that the options were being backdated. After all, any grant of options had to have been approved by the [directors], and [the directors] can be reasonably expected to know the date of the options as well as the date on which they actually approve a grant.

Id. at *9. But if "backdating" implies intentionally improper or unlawful conduct, it is quite simple to posit any number of scenarios where a director might be unaware that an option had been "backdated." Here is one: imagine a stock option grant that was approved not at a Board or Compensation Committee meeting, but using a Unanimous Written Consent (or "UWC") procedure, whereby directors sign and return consent forms approving the action.[12] An outside director who lives in another state receives the UWC, signs it, and returns it to the company's legal department. There is no reason to assume the outside director will know when other directors returned their UWC forms — it is much more reasonable to assume that the director will simply be informed, at some later date, that the grant was approved. In that scenario, the director may not even have knowledge of the mechanics of the approval process (*i.e.*, Chancellor Chandler's "actual approval" date). What is more, our hypothetical director may have no specific knowledge of how the "actual approval" date relates to the "date of the options" that Chancellor Chandler refers to, or how

[12] Plaintiffs here acknowledge that F5's Bylaws authorized F5's Board to take action via Unanimous Written Consent. Complaint ¶ 57. *See* RCW 23B.08.210(1) (permitting action by unanimous written consent if "evidenced by one or more consents describing the action taken, executed by each director <u>either before</u> or <u>after</u> the action taken") (emphasis added). And it is hardly a secret that corporate boards, particularly boards composed primarily of outside directors (who may have other jobs or live in other jurisdictions), routinely proceed using UWCs.

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the interplay of those dates impacts the manner in which such options must be accounted for and disclosed. The recent furor over options "backdating" — and the flood of literature and commentary regarding the proper meaning of that term and the legal implications, if any, of various stock option practices — is stark evidence that the issues are far from obvious. (Recall that the F5 independent investigation, with the assistance of a Big Four accounting firm, took five months and over $7 million to determine which grant measurement dates should not be relied upon.) Thus, in this example, the director in question did absolutely nothing nefarious and certainly did not "lie to shareholders" or commit any fraud.

If one accepts the proposition that a director could (as described above) participate in the approval of an "in the money" option grant innocently (or, at most, negligently), then the *Maxim* rulings collapse.[13] They collapse because, under the heightened pleading standards of Rule 23.1, a derivative plaintiff bears the burden of pleading particularized facts to establish demand futility. In the absence of specific facts demonstrating that specific directors engaged in intentional wrongdoing or deliberately sought to mislead investors (rendering such directors "interested" or trumping the Business Judgment Rule), the default assumption must be that fraud did ***not*** occur. If, as the *Maxim* opinion suggests, a derivative plaintiff need only make the conclusory allegation that "backdating" (*i.e.*, "issuing stock options to an executive on one date while providing ***fraudulent*** documentation asserting that the options were actually issued earlier") occurred, without factual support, then Rule 23.1, and indeed Rule 9(b) and the fundamental pleading standards

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[13] On the same day he issued his Maxim decision, Chancellor Chandler decided another case, *In re Tyson Foods, Inc. S'holders Litig.*, No. Civ. A. 1106-N, 2007 WL 416132 (Del. Ch. Feb. 6, 2007). *Tyson* did not involve allegations of options "backdating," but involved instead a different alleged options practice known as "spring-loading," *i.e.*, issuing options immediately before the announcement of good news that is likely to drive up the company's stock price. *Tyson* is inapposite here because Plaintiffs do not allege that F5 engaged in "spring-loading." But *Tyson* is notable in that Chancellor Chandler acknowledged that "[a] board of directors might, ***in an exercise of good faith business judgment***, determine that in the money options are an appropriate form of executive compensation." *Id.* at *18 (emphasis added). The recognition that, in a vacuum (*i.e.*, divorced from accounting and disclosure considerations), granting an "in the money" option is not improper, nefarious, or inherently deceptive undercuts the fundamental rationale for the *Maxim* ruling.

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applicable to fraud, are nullities. Moreover, if such bald allegations create a *per se* violation of a board's fiduciary duties, then both the demand futility doctrine and the Business Judgment Rule are eviscerated in the option "backdating" context.

The only specific basis in *Maxim* for Chancellor Chandler's conclusion that intentional, nefarious conduct occurred is the so-called "empirical evidence" in the Merrill Lynch analysis. (It is unclear whether Chancellor Chandler would have found that analysis so persuasive had he not already concluded that the *Maxim* directors engaged in fraud.) As an initial matter, F5 respectfully submits that pure speculation of intentional director misconduct, based on even the most compelling statistical data, can never satisfy the stringent pleading burden imposed on a derivative plaintiff by Rule 23.1 and the demand futility doctrine. More to the point, the "empirical evidence" considered by Chancellor Chandler clearly distinguishes *Maxim* from our case. The Merrill Lynch analysis that spawned the *Maxim* litigation identified just ***six*** companies that were the most seriously implicated by Merrill Lynch's statistical methodology, and Maxim was one of those six companies. The statistical analysis evidently showed that the average annualized returns on option grants to Maxim management were ***ten times*** higher than comparable market returns. F5, conversely, is just one of literally hundreds of companies swept up by statistical reviews of stock option grants that compare grant price to fluctuations in stock price. Complaint ¶ 4.[14] There is no evidence in this case comparable to the Merrill Lynch data that Chancellor Chandler obviously found too coincidental to ignore. And Chancellor Chandler specifically noted that his rulings were based on the "unusual facts" of *Maxim* (*id.* at *8), which may explain why the decision is unpublished.[15]

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[14] Plaintiffs will likely trumpet a May 16, 2006 Center for Financial Research and Analysis ("CFRA") report (*see* Complaint ¶ 143) which identified F5 among 17 companies "at risk for having backdated option grants," but the CFRA cautioned that its statistical analysis did not prove that any backdating actually occurred. Plaintiffs also admit that F5 was not implicated by other statistical analyses. Complaint ¶ 4.

[15] *Maxim* is also factually distinguishable from this case because Chancellor Chandler found that the stock option plans at issue "required" all options to be granted at fair market value, and that the "board had no discretion to contravene the terms of the stock option plans." *Id.* at *8. As discussed in Subsection III(C)(1)(a) above, F5's Board had absolute

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The *Maxim* decision reflects the visceral reaction of many to the loaded "backdating" concept. Unfortunately, Chancellor Chandler relied on factually unsupported allegations regarding alleged "fraudulent" conduct, without holding the plaintiffs to the exacting standard of proof required to establish demand futility. F5 respectfully submits that the *Maxim* opinion is questionable law (which will undoubtedly be reviewed by the Delaware Supreme Court) and simply should not be followed.

♦

In summary, even if Plaintiffs are permitted to challenge the option grant transactions, Plaintiffs have failed to establish that demand would have been futile as to those transactions because there are no particularized facts to suggest either **(i)** that the Director Defendants were interested in those grants such that they could not impartially evaluate Plaintiffs' demand, or **(ii)** that the grants were not a valid exercise of business judgment under the Business Judgment Rule. Thus, any claims predicated on the grant transactions must be dismissed.

2. Allegedly Misleading Statements In F5's Proxy Statements.

Plaintiffs' second category of alleged wrongdoing relates to purportedly misleading statements in F5's Proxy Statements. Because Plaintiffs are not challenging any particular transaction, but rather the Board's general disclosure of option pricing practices, the only question for assessing demand futility is whether a majority of the Director Defendants is "interested" in the Proxy Statement issues, such that they would be incapable of impartially evaluating a demand related to those issues. *Cray*, 431 F. Supp 2d at 1121.

Even assuming *arguendo* that the Proxy Statements were materially misleading, plaintiffs' Proxy Statement allegations fail for essentially the same reasons that a challenge to the stock grant transactions would fail. The Complaint contains ***no*** facts — let alone particularized facts sufficient to satisfy the stringent requirements of Rule 23.1 — that connect any of the Director Defendants to

discretion at any time to amend the F5 Stock Option Plans. Given that discretion, the Plans were no impediment to granting "in the money" options if the Board chose to do so.

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the alleged Proxy violations. Instead, Plaintiffs baldly state that the Director Defendants engaged in "a secret, multi-year scheme of backdating stock option grants to themselves and others by using F5's proxy statements and SEC filings to conceal and disguise the fact that such backdating was occurring," and that the Directors would be "required to sue themselves ... which they would not do." Complaint ¶¶ 153, 154(g) and (h). As previously discussed, "the mere threat of personal liability for approving a questioned transaction, standing alone, is insufficient to challenge the disinterestedness of directors. ***In other words, a plaintiff may not bootstrap allegations of futility by pleading merely that the directors participated in the challenged transaction or that they would be reluctant to sue themselves***." *Cray*, 431 F. Supp. 2d at 1122 (emphasis added); *accord Aronson*, 473 A.2d at 809 (allegations that directors "approved" or "participated in, expressly approved and/or acquiesced in" wrongdoing did not excuse demand).

To establish demand futility, Plaintiffs must go well beyond generalized allegations and explain what role the Director Defendants played in issuing the allegedly misleading Proxy Statements. *Rattner v. Bidzos*, No. Civ. A. 19700, 2003 WL 22284323, at *11, 13 (Del. Ch. Oct. 7, 2003) (demand not excused where directors allegedly "should have been on notice of ... alleged misstatements," but no particularized facts established board's involvement in preparing statements: "***The Amended Complaint alleges general knowledge in a conclusory fashion on behalf of the Director Defendants, explained solely by virtue of their service in various capacities***")(emphasis added)); *Guttman*, 823 A.2d at 505-07 (demand not futile where complaint lacked specific allegations that directors had reason to know of misstatements). But Plaintiffs' demand futility allegations are nothing more than "generic and conclusory" assertions virtually <u>identical</u> to those that this Court found to be inadequate in *Cray*. 431 F. Supp. 2d at 1121 n.5 (rejecting as inadequate "allegation that directors breached fiduciary duties" (*cf.* Complaint ¶¶ 154 (a), (c)); "generic allegation of inter-related familiar, business, professional and personal relationships" (*cf.* Complaint ¶ 154(a)); "generic allegation of knowledge of and/or benefits from wrongdoing" (*cf.* Complaint ¶¶ 154(b), (d)); "generic allegation of participation in and/or approval of

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wrongdoing" (*cf.* Complaint ¶¶ 153, 154(b)); "generic allegation that directors would be forced to sue themselves" (*cf.* Complaint ¶¶ 154(g), (i));[16] "allegation that suit by current directors would 'likely expose' directors and officers to further violations of securities laws" (*cf.* Complaint ¶ 154(e)); "allegation that [company] will be exposed to further losses" (*cf.* Complaint ¶ 154(f)); "allegation that directors may face uninsured liability" (*cf.* Complaint ¶ 154(h)).[17] In short, this Court has already considered and rejected Plaintiffs' demand futility allegations.

Because Plaintiffs have not established that demand would be futile as to their Proxy Statement allegations, any claims based on those allegations must be dismissed.

3. Alleged Violations Of GAAP/SEC Regulations.

For their final category of alleged wrongdoing, Plaintiffs claim that F5 violated certain GAAP principles, and certain SEC Regulations regarding executive compensation, by improperly accounting for "in the money" options. According to Plaintiffs, those violations rendered F5's Forms 10-K false or misleading. As with their Proxy Statement allegations, Plaintiffs are not challenging a particular transaction or act of the Board; rather, they are challenging the Director Defendants' oversight of F5's accounting practices and disclosures. As such, the only question for the purposes of demand futility is whether a majority of the Director Defendants is "interested" in the accounting issues, such that they were incapable of impartially evaluating a demand related to those issues. *Guttman*, 823 A.2d 492 (only the first *Aronson* prong applies to accounting violation claims such as these).

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[16] Plaintiffs also allege that "the current Board of Directors has not filed any lawsuits against itself or others who were responsible for [the alleged] wrongful conduct . . . ." Complaint ¶ 154(f). The courts have rejected this theory because it is directly contrary to the Board's "authority to initiate or to refrain from initiating legal actions asserting rights held by the corporation." *White v. Panic*, 783 A.2d 543, 550 (Del. 2001); *Blasband*, 971 F.2d at 1052 ("The Board's failure to take action, ***even if it is aware of wrongdoing***, does not demonstrate [demand] futility") (emphasis added). Moreover, it is not as if F5's Board has not taken any action — it voluntarily launched an extensive independent investigation, and then implemented extensive remedial measures (and restated its financials) in response to that investigation.

[17] *See also Caruana v. Saligman*, No. Civ. A. 11135, 1990 WL 212304, *4 (Del. Ch. Dec. 21, 1990) (demand not excused when "liability insurance has a typical exclusion from coverage of claims brought by [a company] against its directors")(internal quotation omitted); *accord Stepak v. Addison*, 20 F.3d 398, 411 (11th Cir. 1994) (same). This argument is nothing more than a variation of the "directors will not sue themselves" theory.

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The same generic and conclusory demand futility allegations that underpin Plaintiffs' Proxy Statement allegations purportedly apply to their accounting allegations. And those unsupported, non-particularized allegations fail to establish demand futility for the same reasons discussed above. In *Guttman*, the corporation at issue committed accounting errors that required a restatement of the company's financial statements. 823 A.2d at 495-96. The plaintiff made general allegations (akin to the ones Plaintiffs advance here) that the director defendants breached their fiduciary duties by failing to have proper accounting controls in place. *Id.* at 497. The *Guttman* Court found such generalized allegations insufficient to establish demand futility, observing that "[t]he complaint is entirely devoid of particularized allegations of fact demonstrating that the outside directors had actual or constructive notice of the accounting improprieties. Even as to defendant Huang, the only director-defendant who was a manager, the complaint lacks particularized allegations regarding his involvement in the process of preparing the company's financial statements." *Id.* at 498. *See also Stone*, 911 A.2d at 363 ("In the absence of red flags, good faith in the context of director oversight must be measured by the directors' actions to assure a reasonable information and reporting system exists and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome"); *In re Citigroup S'holders Litig.*, No. 19827, 2003 WL 21384599, *2 (Del. Ch. June 5, 2003) (demand not excused in absence of particularized facts showing director knew, or should have known, of illegal practices and poor internal controls).

Plaintiffs' claims here based on alleged violations of GAAP and SEC Regulations fail for the same reasons the claims in *Guttman* failed. With the exception of McAdam, all of the Director Defendants are outside directors. There are no facts alleged in the Complaint regarding what specific role, if any, the Directors played in F5's accounting or public disclosure practices. At most, Plaintiffs allege that the Director Defendants were Directors during the relevant time and, in some instances, served on the Audit Committee. That is insufficient. *See Rattner*, 2003 WL 22284323 at *11 ("The Amended Complaint alleges general knowledge in a conclusory fashion on behalf of the Director Defendants, explained solely by virtue of their service in various capacities"). Nor do

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Plaintiffs allege any "red flags" that would have put the Board on notice of accounting irregularities. *See Guttman*, 823 A.2d at 507 ("[T]he complaint does not plead a single fact suggesting specific red – or even yellow – flags were waved at the outside directors"). Again, it required a five-month, $7 million investigation aided by a Big Four accounting firm for F5 to determine that its financials required restatement — there is absolutely nothing in the Complaint to suggest that any of the Director Defendants were, or should have been, aware of accounting irregularities that might have rendered F5's public filings false or misleading.[18]

Plaintiffs' generic allegations regarding F5's Board's alleged acts and failures connote a claim that the Director Defendants generally failed to properly oversee F5's accounting and disclosure activities. This form of oversight claim — often referred to as a *Caremark* claim — was described by a Delaware Court as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." *In re Caremark Int'l, Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996); *see also Cray*, 431 F. Supp. 2d at 1124. A *Caremark* theory can only prevail if there has been "a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists ...." *Guttman*, 823 A.2d at 506. Just as in *Guttman*, Plaintiffs' Complaint "is empty of the kind of fact pleading that is critical to a *Caremark* claim, such as contentions that the company lacked an audit committee, that the company had an audit committee that met only sporadically and devoted patently inadequate time to its work, or that the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation." *Id.* at 507.

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[18] Plaintiffs allege that F5's restatement was an "admission of falsity." Complaint ¶ 116. That allegation is utterly irrelevant for the purposes of this Motion. The issue on this Motion is whether a majority of the Director Defendants faces a substantial likelihood of personal liability based on the alleged falsity in F5's financials and public disclosures. Because Plaintiffs have failed to plead a single particularized fact that would support such liability, they were not excused from making demand on the Board. *In re Baxter Int'l, Inc. S'holders Litig.*, 654 A.2d 1268, 1270 (Del. Ch. 1995) (court cannot "conclude that there is a substantial likelihood of liability" absent particularized allegations showing directors "ignore[d] obvious danger signs of employee wrongdoing") (internal citation omitted).

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In summary, there are no particularized facts in the Complaint that any of the Director Defendants faces a substantial likelihood of liability based on alleged accounting errors made by F5. As such, demand was not futile with regard to Plaintiffs' GAAP/SEC Regulation allegations, and all claims predicated on those allegations should be dismissed.

D. The Special Committee Was Competent To Respond To Plaintiffs' Demand.

Notwithstanding the foregoing discussion, it is ultimately unnecessary for the Court to consider whether a majority of the Director Defendants was capable of impartially evaluating a demand by Plaintiffs, for this reason: there was a standing committee, composed of disinterested and independent directors, that could have evaluated and responded to Plaintiffs' demand and that could have been given the power to act on behalf of, and to bind, F5's Board.[19]

Before Plaintiffs commenced their initial lawsuit on June 8, 2006, F5's Board had established the Special Committee to investigate F5's stock option practices. The Board had also authorized the appointment of a seventh Director (an outside Director) to serve on that Committee. As of July 14, 2006 — less than 40 days after Plaintiffs filed suit and long before Plaintiffs and their counsel were appointed to lead these consolidated derivative actions — the Special Committee was fully constituted and leading the independent investigation. The Special Committee had two members. The first was Deborah Bevier, the new outside Director with absolutely no connection to the stock option practices at issue in this suit. The second was Gary Ames, a Director who Plaintiffs acknowledge did not join F5's Board until 2004, never served on the Audit Committee, and never granted or received any allegedly "backdated" options. Complaint ¶ 152. Thus, for all the reasons discussed in the preceding Sections, there is absolutely no basis on which to conclude that Mr. Ames was "interested" in any of the alleged wrongdoing on which Plaintiffs' claims are based.

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[19] Plaintiffs may argue that demand is excused because F5's Board created a Special Committee. There are many reasons why such an argument is without merit, including that the Special Committee was created *before* the Plaintiffs' Complaint was filed and *not* in response to derivative litigation.

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Under Washington corporate law, two directors may act on behalf of a Board. The relevant statutory provisions state as follows:

> (1) Unless the articles of incorporation or bylaws provide otherwise, a board of directors may create one or more committees of directors. ***Each committee must have two or more members***, who serve at the pleasure of the board of directors.
>
> . . .
>
> (4) To the extent specified by the board of directors or in the articles of incorporation or bylaws, ***each committee may exercise the authority of the board of directors*** under RCW 23B.08.010.

RCW 23B.08.250 (emphasis added). Had Plaintiffs properly made demand prior to commencing this derivative action, F5's Board could have delegated to the Special Committee not only the authority and mandate to thoroughly investigate the stock option issues (which, in fact, the Board did), but to evaluate and act on Plaintiffs' demand.

It is not clear whether any Court has ever grappled with this precise issue, *i.e.*, how the demand futility inquiry operates in a context where there is an existing committee of disinterested directors who could act on behalf of the Board. In *Beneville v. York*, 769 A.2d 80 (Del. Ch. 2000), the Court was considering whether demand on a board would be futile where the board was evenly divided between interested and disinterested directors. In the course of that analysis, the Court made the following interesting observation:

> Assume, for example, that a corporation, by certificate or bylaw, has a standing litigation committee comprised solely of non-management, independent directors who are empowered to accept demands without involvement by the other board members. Without deciding the question, ***I assume that Delaware courts would give careful consideration to a claim by the defendants that demand must be made in such circumstances.***

Id. at 87 n.16 (emphasis added).[20]

[20] The *Beneville* Court then cited to two other Delaware Chancery Court decisions, but neither case appears to address the stated proposition.

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The *Beneville* hypothetical is quite nearly our case. There *was* a standing committee, consisting solely of non-management, independent directors. The only question is whether F5's Board would have taken the additional step of empowering the Special Committee to evaluate Plaintiffs' demand, but that question is not difficult to answer in light of what, ***in fact***, occurred. The Board gave the Special Committee unlimited authority to fully investigate F5's stock option practices. The Board then accepted all of the Special Committee's findings and its recommendations for remedial measures. It is difficult to imagine the Board, particularly in the bright lights of a joint DOJ/SEC investigation, denying the Special Committee the power to investigate and act on a shareholder demand that was based on all of the same issues and alleged conduct. Indeed, as the *Rales* Court stated:

> The task of a board of directors in responding to a stockholder demand letter is a two-step process. First, the directors must determine the best method to inform themselves of the facts relating to the alleged wrongdoing and the considerations, both legal and financial, bearing on a response to the demand. If a factual investigation is required, it must be conducted reasonably and in good faith. Second, the board must weigh the alternatives available to it, including the advisability of implementing internal corrective action and commencing legal proceedings.

634 A.2d at 935 (internal citations omitted). The Special Committee could have done just that, if Plaintiffs had made demand.

In summary, there may be no need to consider the interest or disinterestedness of a majority of the Director Defendants because there was a standing committee that could have been empowered to act on the Board's behalf. Or, at most, the issue of the disinterestedness of a majority of the Directors should relate solely to whether they were capable of impartially considering *not* whether to "sue themselves," but whether to take the additional step of delegating to the Special Committee the power not only to investigate, but to act on Plaintiffs' demand. Under the circumstances, it seems nearly inevitable that the Board would have taken that additional step. And we need not guess at whether the Special Committee would have given appropriate, serious, thorough consideration to the underlying issues raised by the demand, because, in fact, they did.

F5 respectfully requests that the Court dismiss the Complaint with prejudice.

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Respectfully submitted this 28th day of February, 2007.

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CERTIFICATE OF SERVICE

I hereby certify that on this 28th day of February, 2007, I caused the foregoing to be electronically filed with the Clerk of the Court using the CM/ECF System which will send notification of such filing to the following:

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THE HONORABLE ROBERT S. LASNIK

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

In re F5 NETWORKS, INC. DERIVATIVE LITIGATION.	**Master File No. C06-0794 RSL** **NOMINAL DEFENDANT F5 NETWORKS, INC.'S REPLY ON F5 NETWORK'S MOTION TO DISMISS FOR FAILURE TO MAKE DEMAND** **NOTE FOR MOTION CALENDAR: APRIL 18, 2007 (Deadlines Extended by Stipulated Order)** **ORAL ARGUMENT REQUESTED**

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I. SUMMARY

Nominal defendant F5 Networks, Inc. respectfully submits this Reply to Plaintiffs' Opposition to Nominal Defendant F5 Network, Inc.'s Failure To Make Demand (the "Opposition").

Plaintiffs have pinned the fate of the Consolidated Verified Shareholders Derivative Complaint ("Complaint") to the recent *Maxim* decision (*Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. Feb. 6, 2007)). It is not surprising that plaintiffs hew so closely to Chancellor Chandler's conclusions in *Maxim*, because both the Complaint and the erroneous *Maxim* decision are based on the same fundamental premise, *i.e.*, that improper "backdating" of stock option grants in fact occurred. "Backdating," as both plaintiffs and Chancellor Chandler employ that loaded term, is the practice of deliberately selecting an inaccurate but more favorable option grant date, and then concealing that fact (and the resulting "windfall" for executives or directors) from shareholders and the investing public. *See Maxim*, 918 A.2d at 345 ("Commonly known as backdating, this practice involves a company issuing stock options to an executive on one date while providing fraudulent documentation asserting that the options were actually issued earlier. These options may provide a windfall for executives because the falsely dated stock option grants often coincide with market lows"). In other words, "backdating" equates with ***fraud***. *See also In re CNET Networks, Inc. Deriv. Litig., Case No. C 06-03817*, 2007 WL 1089690, *9 (N.D. Cal. Apr. 11, 2007)("Intentionally employing hindsight to adjust the grant date to an advantageously low price, or 'backdating,' is fraud"). If one starts from the assumption that director defendants committed ***fraud*** in connection with option grants, it requires precious little analysis to conclude that demand on the board of directors to investigate that fraud would be futile.

The critical and fatal flaw in *Maxim* — which also winds inextricably through the Opposition and plaintiffs' allegations in the Complaint — is the erroneous assumption that granting "in the money" options necessarily involves intentional deception or nefarious conduct. Indeed, this Court has already recognized that there is nothing inherently wrong or improper about granting "in the money options," provided a company's granting practices are properly disclosed and accounted for. It is plaintiffs' burden, therefore, to convince this Court not only that the F5 Directors granted "in the money" options, but that those grants were the result of fraud. And in the demand futility context,

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that burden is an extremely onerous one. The relatively lenient Rule 12(b)(6) standard is ***not*** applicable here — plaintiffs must plead ***particularized*** facts (akin to the "ultimate" or determinative facts that would have to be presented at trial) that fraud occurred, if they are to overcome the strong presumption that corporate decision-making should remain with F5's Board. *See Rales v. Blasband*, 634 A.2d 927, 933-34 (Del. 1993) (standard is whether the board addressing the demand "can impartially consider its merits without being influenced by improper considerations").

If plaintiffs' foundational assumption that improper "backdating" occurred at F5 is undermined, then the house of cards that is plaintiffs' Complaint collapses. It collapses because all of plaintiffs' claims are grounded in the assumption that F5's Directors each engaged in, or benefited from, some form of intentional wrongdoing. As discussed in the Motion, and in more detail below, plaintiffs' "backdating" allegations are based purely and completely on trends in F5's stock price and a purported statistical "analysis" of the probabilities of grants occurring on particular dates. That "analysis," which was born of similar analyses that sparked the entire "backdating" conflagration, is hopelessly flawed, as has recently been recognized by leading industry experts. None of the F5 option grants that plaintiffs challenge here warrants any inference that "backdating" occurred. There are reasonable, rational, ***non-fraudulent*** explanations for all of F5's options activity — *even* the grants that ultimately required restatement of F5's financials. In the derivative context, those explanations are sufficient to defeat plaintiffs' bid to usurp the role of F5's Board.

Like securities experts, the courts have also begun to reject the basic premises that underlie the conclusions reached in *Maxim*. Just this month, in the CNET Networks derivative litigation, the Northern District of California rejected a complaint by the very same plaintiffs' counsel (the Lerach firm) containing virtually identical allegations of "backdating." 2007 WL 1089690. Decisions such as *CNET* (which is discussed further below) reflect a burgeoning recognition that in order to allege fraud — especially with the particularity necessary to overcome bedrock principles of corporate governance and the protections of the Business Judgment Rule — would-be derivative plaintiffs must rely on more than mere statistical conjecture. When plaintiffs' conjecture here is debunked, there is nothing left to suggest that F5's Directors are "interested," or that this derivative litigation can or should proceed.

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II. AUTHORITY AND ANALYSIS

A. The Complaint Does Not Adequately Allege That "Backdating" Occurred.

Plaintiffs' Complaint, and all of plaintiffs' claims, are predicated on the assumption that "backdating" occurred at F5, but that assumption is not based on any actual evidence of "backdating." It is premised entirely on a speculative "analysis" that is fundamentally flawed, both as written and as applied by plaintiffs, and on plaintiffs' false assertion that F5 or the Director defendants have "admitted" that backdating occurred.

1. The *Wall Street Journal* Analysis Is Flawed.

As the Court is aware, the current focus on alleged options "backdating" was caused, in large measure, by a March 18, 2006 article in *The Wall Street Journal* entitled "The Perfect Payday." The *Wall Street Journal* article was followed by similar studies conducted by Merrill Lynch and the Center for Financial Research and Analysis (CFRA), all of which purport to identify "abnormal" and "improbable" options patterns, where grants tended to coincide with low points in a company's stock price. (The Merrill Lynch report — and what it implies about Maxim's options practices — constitutes nearly the entire "factual" basis for the *Maxim* decision. *See Maxim*, 918 A.2d at 354.) Plaintiffs here assert that they have "reviewed the stock option granting practices at F5 Networks ... using nearly identical methodologies as *The Wall Street Journal* ...." Opposition at 1:20-21.[1]

As an initial matter, it is critical to recall that none of the "backdating" studies claims to have actually established that "backdating" occurred at any particular company. Plaintiffs erroneously describe the *Wall Street Journal* article as "detailing companies that have misdated options and allowing the market to become aware of the option backdating scandal." Request For Judicial Notice at 3:13-14. Not true. The *Wall Street Journal* article expressly states that none of its analyses "prove chicanery." Similarly, the CFRA report (the only study in which F5 was identified

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[1] In their improperly-filed Request for Judicial Notice, plaintiffs ask the Court to take judicial notice of the *Wall Street Journal* article and the Merrill Lynch report. While the Court can certainly take judicial notice of the fact that the studies were published, and can (as with any secondary source) consider the reasoning used in those studies, the Court should *not* take judicial notice of (*i.e.*, accept as true for the purposes of this Motion) the underlying "facts" that support the studies' conclusions or the conclusions themselves. *See, e.g., Salinas Valley Broad. Corp. v. NLRB*, 334 F.2d 604, 612 (9th Cir. 1964). The statistical analyses undertaken by *The Wall Street Journal* and Merrill Lynch are hardly "widely known in the community" or "readily verifiable." In fact, as discussed further in this section, the conclusions reached by *The Wall Street Journal* are demonstrably flawed.

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in the pool of potentially "suspect" companies; *see* Complaint ¶ 4) specifically cautions that its analysis does not establish that any "backdating" actually occurred. *See also CNET*, 2007 WL 1089690 at *9 ("The [CFRA] report went to great pains to state that it was only assessing risk, not determining whether backdating actually took place"). The studies on which plaintiffs rely do nothing more than explore odds and probabilities, a fact central to any assessment of how such "evidence" logically can, or should be permitted to, support demand futility allegations.

In early March 2007, the Securities and Finance Practice of the well-known and respected firm NERA Economic Consulting published a study entitled "Options Backdating: The Statistics of Luck."[2] In its study, NERA explains in compelling terms why *The Wall Street Journal*'s basic conclusion — *i.e.*, that it is highly unlikely, through the operation of random chance, that a particular company's option grants would repeatedly or consistently coincide with low-points in the company's stock price — is simply wrong. Indeed, if option grants were entirely random, it is a virtual ***certainty*** that at least some of the many thousands of companies' grants would, purely by chance, coincide with stock low-points and appear unreasonably "lucky." As NERA explains, the central fallacy in the *Wall Street Journal* analysis, and in the pack of media and pundit opinions drafting off that analysis, is that "[s]peculation has been rampant about companies that have been very lucky; yet nobody has been paying attention to companies that have been very unlucky."[3] In any normal probability distribution, there will always be "outliers," *i.e.*, instances at either extreme of the bell curve that appear to be highly improbable, but that are just as likely to occur as a particular instance in the center of the curve. The NERA Study uses the example of the New Jersey woman who won the state lottery twice in a four-month period — despite the seeming impossibility of such a thing occurring as a result of random chance, it is (according to NERA) actually *better than even* odds

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[2] *See* Declaration of Brian D. Buckley ("Buckley Dec."), Ex. A. NERA's report has since been discussed in various publications, including *Securities Law 360* (March 8, 2007) and *Business Week Online* (March 9, 2007).

[3] The *Wall Street Journal* analysis embodies this fundamental error because the *Journal* pre-selected "companies that made stock-option grants that were followed by large gains in stock price." NERA Study at 3. From a statistical standpoint, that "prejudgment" distorted the *Journal*'s findings because it introduced a "sample selection bias." *Id.* But that bias is also viscerally apparent: the *Journal* deliberately ***ignored*** the thousands of companies that granted stock options shortly before large ***declines*** in stock price. In other words, the *Wall Street Journal* analysis and its progeny fail to acknowledge or analyze the "unlucky" companies in the probability distribution.

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that, over a seven-year period, *someone* in the U.S. will be a double lottery winner. NERA Study at 4. Thus, *The Wall Street Journal*'s suggestion that it is "wildly improbable" that a company's option grants will randomly coincide with stock price lows is false. It is actually very ***likely***, indeed nearly certain, that some companies will fit that profile. The mere fact of such an occurrence in no way implies, let alone proves, that anything other than chance is at work.

There is another critical fallacy that underlies many "backdating" analyses: that stock option grants are, or should be, entirely random. As NERA observed, it is very likely that companies deliberately grant options at times when they perceive their stock to be undervalued. *See* NERA Study at 2. Granting options during stock price declines serves the dual purpose of (i) making those options potentially more valuable for the recipients (whom the company is seeking to encourage or reward), and (ii) incentivizing recipients to all "pull on the same oar" to increase the stock's value. Indeed, *The Wall Street Journal* acknowledged that exact dynamic.[4] Thus, since companies are in fact deliberately granting options during stock price troughs, one would expect the normal random probability distribution to skew toward the "lucky" end of the bell curve. And, based on NERA's analysis of options practices (removing the biases introduced by *The Wall Street Journal*), that is *precisely* what occurs. NERA Study at 4.

What do the flaws in the *Wall Street Journal* analysis, which plaintiffs have adopted, mean for the Court's assessment of demand futility? Plaintiffs' burden in the demand futility context is extremely high (and much more onerous than under Rule 12(b)(6)). They must plead ***particularized*** facts establishing why demand should be excused. The Delaware Supreme Court has referred to such allegations as being in the nature of "ultimate facts" or "elemental facts," *i.e.*, those specific facts that would actually sustain a claim. *See Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000). If this case were to proceed to trial, could plaintiffs possibly hope to prove liability based solely on a *Wall Street Journal*-style statistical analysis? Surely not. Without some indicia or evidence of

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[4] *See* "The Perfect Payday" at 3 ("It's also possible companies sometimes award options after their stock has taken a fall and seems to them to be undervalued. In point of fact, the companies can't possibly know what the stock will do next, but that doesn't mean they might not feel confident enough about a recovery to think they are hitting a favorable time to grant options"). There is no suggestion that trying to *predict* a stock price increase is somehow improper.

"backdating" (*i.e.*, of fraud), there is no reason to conclude that F5 (or any other company accused of "backdating") is not simply the random statistical outlier, the double lottery winner. Plaintiffs have ***no*** evidence or indicia of fraud; they have only "probabilities" and conjecture, but (as discussed above) their statistical "analysis" does not logically imply, let alone establish, that any wrongdoing occurred. If such conjecture could not carry the day at trial (which it clearly could not), it cannot suffice in the demand futility context. *Brehm*, 746 A.2d at 254.

Plaintiffs' Opposition treats as a foregone conclusion this Court inexorably and blindly following *Maxim*. The Court is in no way bound by the *Maxim* decision (and not just because *Maxim* is an unpublished trial court decision not yet tested by appeal). "[A] court that is entertaining a derivative action ... must apply the demand futility exception as it is defined by the law of the State of incorporation," *Kamen v. Kemper Fin. Serv., Inc.*, 500 U.S. 90, 108-09 (1991), and F5 is a Washington corporation.[5] In the Motion, F5 explained in detail why *Maxim* is bad law and should not be followed by this or any other court. *See* Motion at 23-28. (Plaintiffs conspicuously fail to address ***any*** of the critical flaws in the *Maxim* analysis, instead simply citing *Maxim* as the last word on these "backdating" issues.) F5 will not repeat that discussion here, but it bears repeating that Chancellor Chandler's conclusions in *Maxim* turn the demand futility standard on its head. Under *Maxim's* reasoning, the ***only*** thing a plaintiff need allege with particularity is a statistical ***implication*** that a company's options practices are the result of something other than random chance. Chancellor Chandler even acknowledged that the Merrill Lynch report on which his entire opinion rests does not conclude that any "backdating" actually occurred. 918 A.2d at 347 ("Merrill Lynch failed to take a position on whether Maxim actually backdated; however, it noted that if backdating did not occur, management of Maxim was remarkably effective at timing options pricing events").

[5] Judge Downing, the King County Superior Court judge presiding over the consolidated state court derivative actions pending against F5, did not feel at all constrained to follow *Maxim*. In *Maxim*, Chancellor Chandler refused to stay the Delaware state court derivative action in favor of a virtually identical action pending in federal court in California, invoking the Chancery Court's interest in interpreting and applying Delaware state law. 918 A.2d at 351. Judge Downing, however, readily stayed the state court actions against F5 in favor of this action. Moreover, as noted in the Motion, *Maxim* is a decision from Delaware's lowest court that departs drastically from decades of established law on demand futility — Chancellor Chandler's decision will undoubtedly be appealed, and given the likelihood that it will either be reversed or substantially pared back, there is no reason to view *Maxim* as setting the new standard.

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F5 urges this Court to reject the premise that, in the demand futility context, a statistical analysis of probabilities, standing alone, is sufficient to establish fraud, and thereby overcome the strong presumption against permitting shareholders to usurp the fundamental role of a company's board of directors to manage corporate affairs.[6] It is doubly appropriate to reject that premise where the statistical analysis in question does not support an implication, let alone a finding, that anything other than random chance was at work.

In summary, contrary to plaintiffs' assertions, the Complaint does ***not*** adequately plead that "backdating" occurred at F5. The Complaint pleads literally nothing more than statistical conjecture. When the basic "backdating" ***assumption*** is dispelled, all of plaintiffs' claims necessarily fail, because all ***assume*** that the Directors participated in wrongdoing.

2. Plaintiffs' "Backdating" Analysis Compounds *The Wall Street Journal*'s Errors.

As discussed above, plaintiffs claim to have analyzed F5's option granting practices "using nearly identical methodologies as *The Wall Street Journal*." Plaintiffs' conclusions are therefore as fundamentally unsound as the *Journal*'s basic conclusion that random chance could not produce a scenario where a company's grant dates repeatedly coincided with stock price lows. But plaintiffs start with the errors in the *Wall Street Journal* analysis and substantially compound those errors through their own "analysis" of F5's option grants. The additional erroneous and misleading assumptions and tactics employed by plaintiffs are each discussed below.

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[6] In *CNET*, Judge Alsup reached the correct conclusion in finding that the CNET plaintiffs (and their counsel, who are here urging the same theories and arguments on this Court) failed to adequately plead demand futility. But Judge Alsup erred in accepting the proposition that the mere timing of an option grant, compared with the subsequent performance of the stock, can, under certain circumstances, be sufficient to imply that "backdating" occurred. *CNET*, 2007 WL 1089690 at *11 ("Given the twofold increase in stock price and the lapse of time between the grant date and the press release, plaintiff has pleaded facts that support the inference that this grant was backdated"). F5 respectfully submits that an "inference" of fraud, based on events that could just as readily be the result of chance or innocent events (as discussed further in the following section), should never be sufficient to support a demand futility argument. Judge Alsup should have followed the lead of his colleague on the bench, Judge Chesney, and "held that merely alleging that options were granted at a periodic low in stock price that was followed by a sharp jump in price was not sufficient to plead a pattern of backdating. More facts, including how often and at what times past stock options were granted, were needed to show a pattern." *Id.* (citing *In re Linear Tech. Corp. Deriv. Litig.*, 2006 WL 3533024 at *3 (N.D. Cal. Dec. 7, 2006)). Plaintiffs try to distinguish *Linear* by arguing that those defendants "strongly disputed" that the director defendants had engaged in "backdating," but that here F5 has allegedly "admitted" that it falsely reported certain option grants. Opposition at 16 n.9. It should go without saying that F5's Directors "strongly dispute" that they engaged in any form of wrongdoing whatsoever. More to the point (and as discussed at length in the following section), plaintiffs' contention that F5 or the Director defendants "admitted" that "backdating" (*i.e.*, fraud) occurred is a gross mischaracterization of the facts.

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a. **<u>Plaintiffs Do Not Even Properly Apply *The Wall Street Journal's* Analysis.</u>**

In *CNET*, plaintiffs' counsel claimed, as they do here, that their analysis of CNET's options practices "follow[ed] in the footsteps of the widely-accepted analytical model used by *The Wall Street Journal* and the CFRA to reveal the nationwide backdating scandal." 2007 WL 1089690 at *10. Calling that contention "disingenuous," the *CNET* Court stated:

> It seems, however, that plaintiffs only followed those footsteps halfway. For instance, after looking at the twenty days after the grant date, the *Wall Street Journal*'s study ranked the returns in that period against all other possible grant dates within the year to establish how unusual, versus the rest of the stock's behavior, the activity following the grant date was. The CFRA study compared the number of at-risk grants to the total number of grants. ***Plaintiffs made no such comparisons. They barely used an analytical model at all. They merely looked at the stock price movement.***

Id. (emphasis added). We have precisely the same situation here. Plaintiffs have not considered relative percentage return on the few option grants they attack, nor have plaintiffs made any attempt to place those grants into the broader context of F5's total option granting patterns. Instead, plaintiffs merely reviewed stock price movements and concluded, "[b]ased on the abnormal price declines and abnormal price increases shortly before and after these grants, they ***appear*** to have been made with the benefit of hindsight, *i.e.*, were backdated." Opposition at 2 (emphasis added).[7]

Plaintiffs attempt to bolster their anemic "analysis" of F5's option grants by comparing particular grant prices to the "weighted average closing price" of F5's stock for the entire fiscal year. For example, plaintiffs allege that "[d]uring fiscal year 2000, the trading price of F5 common stock ranged from a price of $29.25 to $155.88 per share, with a weighted average closing price of $71.70." Complaint ¶ 62. (Plaintiffs never explain what they mean by "weighted average closing price" or how they calculated those figures.) Plaintiffs then address an October 1, 1999 option grant

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[7] Plaintiffs never explain how an "abnormal" price decline prior to an option grant is evidence of "backdating." As discussed above, it is logical and entirely proper that a company will grant options when its stock appears undervalued, such as after a long price slide. And the company would obviously have no incentive to look back up the hill for a higher stock price. The "backdating" implication only arises when the stock price begins to *climb* again, and the company appears to have looked back for a lower, more favorable price. Moreover, by their own admission, plaintiffs have introduced the "sample selection bias" identified by NERA because plaintiffs focused only on grants that fit their pre-selected notion of what a "backdated" grant looks like and ignored all the "unlucky" grants.

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to an F5 executive at an exercise price of $68.06, "which is $3.64 less than the weighted average closing price for the fiscal year." This comparison reveals nothing. In a fiscal year, approximately half the daily stock prices will be above the average and approximately half will be below the average (excluding daily prices that are exactly the average). For all the reasons discussed above, it would hardly be surprising if many option prices fell below the average for the year, given companies' various incentives for properly granting options after stock prices have declined. So the observation that a particular grant price was "below the weighted average" is neither particularly surprising nor at all revealing. Moreover, in a year when F5's stock price swung between $29 and $155 per share, what possible significance can be attached to a grant price that is $3.64 less than the weighted average? As the *CNET* Court noted, none of plaintiffs' arguments or observations reflects an analytical model — plaintiffs are merely shuffling numbers, hoping the façade of analysis will mask the fact that their "backdating" allegations lack any substance.[8]

In summary, although *The Wall Street Journal's* analysis is flawed, it was at least based on a principled analytical model. Plaintiffs have not engaged in any "analysis" at all. Instead, plaintiffs searched for stock price patterns that fit plaintiffs' preconceived notions of the indicia of "backdating," and then painted the fraud bullseye around the arrow.

b. <u>Plaintiffs' Focus On The 20-Day Post-Grant Period Is Misleading.</u>

The Complaint largely consists of graphs (truncated or elongated for maximum effect) showing a challenged option grant and then an allegedly dramatic run-up in F5's stock price in the

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[8] In some instances, even the basic data that plaintiffs rely on is inaccurate. For example, plaintiffs challenge an April 20, 2001 option grant, claiming it was priced at the "lowest closing price for the stock for the month of April 2001." Complaint ¶ 9 (p. 4:17-22). That assertion is not just wrong but egregiously wrong. In fact, the April 20, 2001 price ($8.10) was the second ***highest*** price for the month of April 2001. And after the grant, F5's stock price immediately ran ***down*** to $7.00 per share and did not trade above $8.10 again until May. *See* Buckley Dec., Ex. B. (For the Court's ease of reference, Exhibit B is a chart of daily F5 stock prices for the entire period challenged by plaintiffs in the Complaint.) Similarly, plaintiffs contend that the $7.00 strike price for an April 27, 2001 grant was "one of the lowest" for the month. Complaint ¶ 9 (p. 4:23-24). In fact, $7.00 was nowhere near the low point of $3.75 for April 2001, nor was it near any other discernible low point. To the contrary, the April 20, 2001 option price was in the middle of a sustained <u>rise</u> in F5's stock price, beginning at prices below $4.00 in early April and rising to above $17.00 by early July 2001. The April 27, 2001 grant is one that plaintiffs specifically call out as a "startling example of stock option backdating." Opposition at 16. The April 2001 grants would have been supremely ineffectual "backdating."

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20 trading days following the grant. Plaintiffs then calculate the "20-day cumulative return based on the exercise price," apparently as a metric for the magnitude of the alleged "backdating." Plaintiffs never explain what the "20-day cumulative return" purportedly reflects or how it is calculated. But the implication plaintiffs hope to conjure is that nefarious "backdating" permitted defendants to take advantage of the full 20-day run-up in the stock price.[9] In fact, plaintiffs' 20-day "run-up" theory is squarely undermined by judicially-noticeable facts.

Directors and certain corporate officers who receive option grants are required to report those options to the SEC using Form 4. After Sarbanes-Oxley, that reporting is supposed to occur within two days of the option grant. 15 U.S.C. § 78p(a)(2)(C) (effective in August 2002). The date on which the first Form 4 is filed reflecting a particular option grant (and the corresponding exercise price) obviously establishes the last possible date on which alleged "backdating" could have occurred. It would be impossible for "backdating" to occur after that point because the grant and the strike price have already been publicly disclosed. *See CNET*, 2007 WL 1089690 at *14 ("It is highly unlikely that defendants could have gone back in time to change the date for this grant if it was on record with the SEC two days after the fact").

In many instances, plaintiffs' implication that a 20-day run-up in F5's stock price after an option grant is attributable to the improper use of hindsight is negated by the reporting of the grant just days after it occurred. For example, plaintiffs question options granted by F5 on April 29, 2004 (with a strike price of $28.10) and April 30, 2004 (with a strike price of $25.49). Plaintiffs note that the stock price at the end of the 20-trading-day period following the grants was $29.47, suggesting that the options were "backdated" to take full advantage of that 20-day increase. What plaintiffs fail to note, however, is that the option grants were reported to the SEC on May 6, 2004, less than a week after the grants occurred. And the stock price on May 6, 2004 was $26.90, which is $1.20 ***less***

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[9] Stated differently, the stock price 20 days after the option grant date is only relevant for purposes of plaintiffs' claims if the defendants looked back from that 20th trading day to pick the exercise price. If, alternatively, the defendants actually looked back from an earlier date (for example, 10 trading days after the grant date), the improper "hindsight" that plaintiffs allege was utilized could only logically apply to that 10-day period. In that example, the stock's performance after the 10th trading day — the date the hypothetical "backdating" occurred — would be the result of chance, not improper hindsight.

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than the April 29 grant price.[10] Similarly, plaintiffs challenge a May 8, 2003 option grant at an exercise price of $14.64, citing a 20-day run-up in F5's stock price to $17.38. Complaint ¶ 71. What plaintiffs conveniently omit is that the grant was reported only two trading days later, and in the interim day the stock price rose only $.80.[11] In fact, for seven of the twelve grants plaintiffs challenge, the grant was first reported to the SEC earlier than 20 trading days after the grant.[12] This is yet another example of how plaintiffs' purported statistical "analysis" is just sleight-of-hand.[13]

c. <u>Plaintiffs Ignore That Most Options Are Subject To Vesting Requirements</u>.

According to plaintiffs, the material harm that is purportedly caused by "backdating" is that executives and directors receive a significant financial benefit, a "windfall," because their options are immediately and automatically "in the money."[14] That alleged harm is based on an assumption that "in the money" options can be immediately exercised and the "windfall" captured. Plaintiffs' theory fails, however, to account for the fact that most of the F5 options that plaintiffs are challenging were subject to vesting requirements and so could <u>not</u> be immediately exercised. The options associated with eight of the twelve grants plaintiffs challenge were subject to vesting

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[10] *See* Buckley Dec., Exs. M-N (Forms 4 reporting the April 29 and 30, 2004 option grants).

[11] *See* Buckley Dec., Ex. L (Forms 4 reporting the May 8, 2003 option grant). It is also worth noting that the May 8, 2003 grant immediately followed a month-long stretch when the stock had traded below (at times well below) $14.64. If defendants had truly been "back-casting" for favorable dates, they had a panoply of better dates to choose from.

[12] *See* Buckley Dec., Exs. G-I, K-N (Forms 4, and one Form 3, for the relevant option grants, listing the reporting dates).

[13] There are yet more examples of plaintiffs' legerdemain. In an attempt to add weight to their claims, plaintiffs repeatedly refer to the aggregate value of option grants, or exercised options, as "illicit" or a "windfall." *See, e.g.*, Opposition at 4:24-25 ("$67.7 million worth of illicitly backdated options"); 6:12 ("a windfall of over $161 million"). But even if plaintiffs' theory were correct that the strike prices for these options were "backdated," the only "illicit" portion of those grants would be the value associated with the "backdating," not the entire value of the grant. In the same vein, plaintiffs refer generally to options exercised by F5's Directors in the relevant time period, but never connect <u>any</u> of those exercised options to the challenged grants. It may be that the exercised options were obtained pursuant to grants that are entirely free of any "backdating" taint or suspicion. The Complaint is silent on that issue.

[14] Plaintiffs contend that "the backdated option grants carried a much higher intrinsic value at the time they were granted. This improperly inflated value went straight into the pockets of defendants, rather than the Company, on a dollar for dollar basis." Opposition at 5:18-21. This is a puzzling statement. <u>First</u>, the "intrinsic" value of the options did not go "straight into the pockets of defendants" — the theoretical value of the options could only be realized if the options were exercised, and many of the options (particularly those issued early on when the F5's stock was trading above $100 per share) were never exercised or cashed out (because they rapidly became worthless as F5's stock price declined). <u>Second</u>, there is no explanation of how the theoretical value associated with an allegedly "backdated" option would have otherwise enriched the Company on a "dollar for dollar basis." "In the money" options are a non-cash "expense"; they cost F5 nothing.

requirements.[15] Under those vesting restrictions, none of the subject options were fully vested before one year from the grant date, and some were not fully vested until three years from the grant date, as demonstrated by the publicly-filed Forms 4.

The theoretical "paper" gain that "backdating" might generate has no actual immediate value if the options are subject to vesting. And "backdating" non-vested options has very dubious long-term value (particularly for options that vest over many months or years) because it is impossible to predict how the stock price will perform in the future. Indeed, it can reasonably be argued that vesting requirements effectively defeat ***any*** incentive to "backdate" because those requirements negate the ability to guarantee a profit to option recipients. Plaintiffs' failure to analyze, or in any way account for, the option vesting requirements further weakens any inference that can be drawn from plaintiffs' options "analysis."

3. F5 Did Not "Admit" That "Backdating" Occurred.

Plaintiffs repeatedly contend that F5 has "admitted" that the Company engaged in "backdating," because F5 restated its financials as a result of the internal investigation the Company conducted in the summer of 2006. *See, e.g.*, Opposition at 2:16-17. That contention is a gross mischaracterization of the bases for F5's restatement and distorts the facts. F5 has never concluded, let alone "admitted," that "backdating" occurred — in fact, there are legitimate, non-fraud-based explanations for the grant dates of all the options that underlie F5's restatement. As the *CNET* Court noted, it is improper to draw an inference of "backdating" when there is an equally plausible, non-fraud-based explanation for the timing of an option grant. *See CNET*, 2007 WL 1089690 at *13.

In its Form 10-K/A(2) for fiscal year 2006, F5 publicly disclosed the results of its internal investigation into historical option grants at the Company. F5 disclosed the Special Committee's conclusion that "the recorded grant dates for certain stock options granted during fiscal years 1999 through 2004 should not be relied upon as the measurement date for accounting purposes and that the accounting treatment used for the vesting of certain stock options was incorrect." 2006 Form

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[15] *See* Buckley Dec., Exs. D-G, I-J, L, N (Forms 3 and 4 for the relevant option grants, listing vesting requirements).

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10-K/A(2) at 21.[16] As a result of those findings, it was necessary for F5 to restate its financials to correct the erroneous accounting. Further, F5 specifically identified five issues that called into question certain grant measurement dates. *Id.*; *see also* Opposition at 8:4-10 (quoting the purported "admissions" from the 10-K/A). None of those issues involves a finding or conclusion that any measurement date had been deliberately "backdated" to a more favorable date. None of the issues identified by the Special Committee (each of which is discussed further below) involves, either necessarily or by implication, improper "backdating."

Allocation Issues. In its 2006 Form 10-K/A(2) (p. 21), F5 disclosed the following as the first issue underlying the Company's restatement: "The Company used improper measurement dates in connection with certain annual stock option grants to employees because the number of shares certain individual employees were entitled to receive was not determined until after the original grant date." This is what has come to be commonly referred to as an "allocation" issue. It occurs when a board or compensation committee approves a general grant of a pool of options, but it is then up to management, with input from department heads and supervisors, to allocate that pool of options among all eligible employees. The SEC Office of the Chief Accountant has recognized that, under applicable accounting rules, the "measurement date" for such a grant — *i.e.*, the date that drives the proper accounting treatment, which is *not* necessarily the date the grant was actually "approved" — cannot be determined until the allocation of the options is "final" (but the SEC recognizes that there are any number of scenarios that might constitute "finality"). *See* September 19, 2006 Guidance Letter from SEC Chief Accountant ("SEC Guidance Letter") at 3-4.[17] None of F5's outside Directors would have had any involvement in, or even visibility into, the process of management's allocation of options — after the pool of grants is approved, the allocation of those grants would be wholly outside the Directors' awareness or control.[18] Nor do plaintiffs allege to the

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[16] Plaintiffs submitted F5's 2006 Form 10-K/A(2) as Exhibit 1 to plaintiffs' Request for Judicial Notice.

[17] The SEC Guidance Letter is available on the SEC's website at http://www.sec.gov/info/accountants/staffletters.shtml. A copy is attached to the Buckley Declaration as Ex. O for the Court's reference.

[18] For the purposes of this Motion, it is critical to remember that five of the six F5 Directors at the time this suit was filed were outside Directors. Only one Director, John McAdam, was a Company employee. Complaint ¶¶ 26-32.

contrary. Thus, this issue does not involve "backdating" at all; it is simply a factual question as to when the allocation of options was sufficiently "final" to establish a measurement date.[19]

Start Date Issues. The second issue underlying F5's restatement was disclosed as follows: "The Company granted options to certain new employees and board members prior to their start dates." 2006 Form 10-K/A(2) at 21. This is another circumstance where the Board or Compensation Committee approves a general type of grant (*i.e.*, a grant for new hires) that is then executed by management or staff. There is no reason to believe that an outside F5 Director would know what date the Company deemed to be a particular employee's (or even a fellow Director's) official start date. That is an issue that would clearly be determined by the employees (maybe even by lower-level employees in the human resources or staffing department), not by the Board or Compensation Committee. Nor do plaintiffs specifically allege to the contrary. And nothing in F5's disclosure regarding start date issues implies that "backdating" occurred. It is just as reasonable (if not more so) to assume that an employee's proposed start date was established, but the employee actually began work at a later date and the original start date was never changed. There is no evidence (in either the Form 10-K/A or the Complaint) that anyone at the Company was deliberately casting back for more favorable grant dates prior to commencement of a person's employment.

Documentation Issues. The third issue related to F5's financial restatement was disclosed as follows: "The Company did not have sufficient documentation to support certain measurement dates and did not obtain the necessary approvals for stock options issued to certain individuals." 2006 Form 10-K/A(2) at 21. The first part of this statement is not even a recognition that the measurement date at issue was necessarily wrong, just that there was insufficient documentary evidence to support why it was chosen. There is no conclusion, implicit or otherwise, that any grant date was "backdated." For example, it might be that it is difficult to pinpoint from email traffic or

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[19] Allocation issues arise in connection with annual Company-wide option grants, rather than the *ad hoc* grants to executives and Directors that plaintiffs primarily challenge here. *See* 2006 Form 10-K/A(2) at 21 (referring to "Improper Measurement Dates for Annual Stock Option Grants"). The allocation issues that F5 experienced account for well over half of the non-cash compensation expense that was the subject of the Company's restatement. *Id.*

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other internal documentation when the option allocation process was finally completed. Or maybe the documentary record is unclear as to when the final Uniform Written Consent form came in from outside Directors approving a particular grant. There is nothing that suggests these sorts of administrative and record-keeping issues involved any deliberate "back-casting" by Directors for more favorable grant dates. And the second part of the statement has nothing at all to do with how measurement dates were chosen, thus it cannot possibly implicate "backdating."

Consultant Issues. The fourth issue underlying F5's restatement was disclosed as follows: "The Company did not properly account for stock option grants issued to a consultant who later became an employee." 2006 Form 10-K/A(2) at 21. This is not a "backdating" issue at all. It is merely a recognition that improper accounting treatment was applied to a particular consultant grant. Any such accounting treatment would presumably have been reviewed and approved by the Company's auditors, and there is no allegation, let alone evidence, whatsoever that the Board or Compensation Committee had any involvement in the issue.

Grant Modification Issues. The final issue related to F5's restatement was disclosed as follows: "The Company did not properly account for stock options of certain individuals that were modified after the grant date." 2006 Form 10-K/A(2) at 21. Again, this is simply not a "backdating" issue. This is an accounting issue that does not necessarily implicate any of the Directors, let alone suggest that they were guilty of some deliberate manipulation of grant dates. In fact, the events that triggered the accounting issues in this instance occurred <u>after</u> the grant measurement dates were chosen, *i.e.*, the options were subsequently changed in some way, which affected the proper accounting treatment.

One of the option grants to which plaintiffs point as reflecting "a high likelihood that option grants were backdated" — the January 1, 2001 grant (Complaint ¶ 65) — illustrates vividly how such grant modification issues might play out. The SEC Chief Accountant recognized that "[s]ome companies have awarded options with provisions designed to protect an employee from immediate declines in the stock price. Typically, these awards do not have a stated exercise price at the award approval date but instead include a ***formula*** for establishing the exercise price. For example, ***an***

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award may establish an exercise price as the lowest market price of the company's stock over a 30-day period beginning with the award approval date. " SEC Guidance Letter at 7 (emphasis added). As the Chief Accountant recognized, there is nothing wrong with such an approach; it simply requires variable accounting until such time as the contingency (*i.e.*, which day of the month will have the lowest stock price and, therefore, constitute the measurement date) is resolved. *Id.* Plaintiffs infer improper intent from the fact that the January 1, 2001 grant was priced at "the lowest price of F5 stock for the month of January" (Opposition at 16), but that could easily have been the result of a pre-set formula. Agreeing, in advance, to use the lowest date in a period as the measurement date involves no "backdating" whatsoever; it merely reflects granting of options subject to a future contingency.

Indeed, the use of a pre-set formula (and the SEC Chief Accountant's recognition that such an approach is acceptable and common) eliminates the superficial appeal of plaintiffs' "backdating" allegations. For seven of the twelve grants that plaintiffs challenge, plaintiffs allege (albeit erroneously in certain instances) that the grant was priced at the lowest closing price for the stock in the relevant month. *See* Complaint ¶ 9. But plaintiffs provide no evidence or analysis regarding whether those exercise prices were determined pursuant to a pre-set grant formula. In the absence of such evidence and some specificity, plaintiffs' general statistical aspersions are patently insufficient to establish ***with particularity*** — or even to infer — that F5 or its Directors engaged in fraud.

The bottom line is that all of the issues identified by F5 as leading to a restatement of the Company's financials — and a recognition of additional non-cash compensation expense — were ***accounting*** issues, not "backdating" issues. As the *CNET* Court noted, "[t]he Chief Accountant's Office of the SEC has identified a few instances where a company could use the wrong measurement date through sloppy accounting practices not rising to the level of fraud." 2007 WL 1089690 at *8 (citing the SEC Guidance Letter). The *CNET* Court noted that allocation issues, start date issues, and documentation issues (like those experienced by F5) could all result, ***non-fraudulently***, in improper measurement dates: "The common thread to all of these scenarios is that determining the correct measurement date depends on the facts. This dependence can admit the possibility of

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innocent error – ***using an incorrect measurement date to price the options with no intent to find an advantageously low price***." *Id.* at *9 (emphasis added).[20] F5's disclosures regarding the findings of the Special Committee do not suggest that anything other than innocent error led to F5's restatement. In fact, there is no evidence that F5's Directors (whose state of mind is ultimately what matters here in determining their personal "disinterest" in these issues) would even have known the measurement dates chosen by the Company for accounting purposes.[21] Absent some evidence reflecting that the Board or Compensation Committee identified a specific grant date and specific strike price for a particular set of options, it is just as reasonable (and probably more reasonable) to assume that the measurement date was ultimately chosen by management or staff.[22]

The innocence of the Company and the defendants is bolstered by the Special Committee's findings. F5 disclosed that, "[b]ased on its investigation, the Special Committee concluded that it continued to have confidence in the ability of the Company's current senior management to serve in their positions with integrity at the Company. The Special Committee was unable to reach any conclusions regarding the intent of former officers, directors and employees." 2006 Form 10-K/A(2) at 21. The *CNET* Court recognized the importance of a special committee finding in the demand futility context: "Plaintiffs would also have the Court ignore that the special committee concluded

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[20] While F5 restated its financials to recognize additional non-cash compensation expense associated with certain option grants, none of those grants was actually *re-priced*. That suggests that any errors in the grant measurement dates inhered in the accounting treatment and were *not* the result of deliberate or nefarious conduct that would justify retroactively modifying the grants to correct strike prices. In *CNET*, the Special Committee's findings *did* mandate that certain options be re-priced, and the Court found that even that fact did not support an inference that fraud (*i.e.*, "backdating") had occurred. 2007 WL 1089690 at *15.

[21] Nor is there evidence that F5's Directors would have known the specific accounting treatment afforded particular grants. Under Washington law, directors are permitted to rely on information, opinions, and reports (including financial data) prepared or presented by, *inter alia*, officers and employees of the corporation, board committees, and public accountants. RCW 23B.08.300(2). The accounting rules governing options are extremely complex; plaintiffs have presented no evidence to suggest that any particular F5 Director would have been involved in specific accounting determinations. *See CNET*, 1089690 at *16 (directors entitled to rely on employees and experts).

[22] This also points up the related fact that plaintiffs have failed to connect any of the issues that F5 disclosed in its 2006 Form 10-K/A(2) to any of the option grants that plaintiffs challenge in the Complaint. Indeed, there is no evidence that any of the challenged grants actually contributed to the Company's restatement. It is plaintiffs' burden to establish that particular grants were "backdated" and that a majority of the Director defendants were "interested" in those grants. F5's disclosures (even if they could be characterized as "admissions") do not reduce plaintiffs' burden, because there is no link between those disclosures and the allegedly suspect grants.

that there was no wrongdoing by any current or recently resigned directors or officers. In view of this statement, the inference that fraud still occurred despite an investigation and the eventual public release of results is ***improper absent other facts indicating fraud***." 2007 WL 1089690 at * 15 (emphasis added). Here, all of the Special Committee's conclusions and F5's public disclosures are consistent with innocent accounting errors and <u>none</u> implicates "backdating." *See CNET*, 2007 WL 1089690 at *13 ("***Mere reliance on the numbers is not sufficient when plaintiffs are confronted with a legitimate, judicially-noticeable explanation for the grant date***. To plead with particularity that this grant was backdated, plaintiffs would need to allege specific facts showing that this was not the true grant date")(emphasis added).

B. <u>F5 Did Not Violate The Stock Option Plans</u>.

A major component of plaintiffs' demand futility argument is the allegation that F5 violated the terms of its Stock Option Plans by granting options priced at less than "fair market value" on the date of the grant. *See, e.g.*, Opposition at 18-19. Plaintiffs harp on that allegation because *Maxim* hinges on Chancellor Chandler's conclusion that Maxim's directors intentionally violated certain provisions in Maxim's stock plans. *See Maxim*, 918 A.2d at 358 ("I am unable to fathom a situation where ***the deliberate violation of a shareholder approved stock option plan*** and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith") (emphasis added); Opposition at 18:12-14 ("Here, as in *Ryan*, it is indisputable that defendants Higginson, Guelich, Grinstein and Malone breached their fiduciary duties of loyalty and good faith as members of the Compensation Committee when they granted backdated stock options in direct violation of the Stock Option Plans"). But even if plaintiffs were correct that F5 deliberately granted options at less than fair market value (which, as discussed above, plaintiffs have clearly failed to demonstrate), plaintiffs have *not* adequately alleged that such a practice would have violated the F5's Stock Plans.

As noted in the Motion, the 1998 Equity Incentive Plan expressly authorized F5's Board or Compensation Committee to grant "in the money" options. The 1998 Plan stated: "[T]he exercise price of each Nonstatutory Stock Option granted prior to the Listing Date shall be not less than eighty-five percent (85%) of the Fair Market Value of the stock subject to the Option on the date the

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Option is granted. The exercise price of each Nonstatutory Stock Option granted on or after the Listing Date shall be not less than fifty percent (50%) of the stock subject to the Option on the date the Option is granted." 1998 Plan § 6(c) (*see* Keehnel Dec. (filed in conjunction with the Motion), Ex. I). Thus, Nonstatutory (also referred to as Nonqualified) Stock Options (or "NSOs") could be granted at prices as low as ***50%*** of fair market value on the grant date. And F5 expressly disclosed to the public that F5 not only could, but ***did***, on occasion, grant "in the money" options.[23] Finally, and most importantly, the Forms 4 filed in connection with the twelve grants plaintiffs challenge reflect that ***all*** of the options subject to those grants were NSOs.[24]

Thus, plaintiffs have not alleged particularized facts supporting an inference that F5's granting of "in the money" options (if, in fact, any of the challenged grants were "in the money" on the grant date) violated the Stock Option Plans, because the 1998 Plan expressly permitted NSOs to be below market, ***all*** of the challenged options were NSOs, and it can just as reasonably be inferred that those options were granted under the 1998 Plan as some other plan.[25] Therefore, the critical factual premise that drove the result in *Maxim* is wholly lacking here.

C. F5's Directors Did Not Receive Or Grant "Backdated" Options.

The bulk of the Opposition is devoted to plaintiffs' assertions that F5's Directors are not sufficiently "disinterested" (because they "face a substantial likelihood of liability" or "failed to exercise business judgment"), based on the Directors allegedly having either received or granted

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[23] *See* F5 Form 14A (Proxy Statement) filed January 18, 2000 (Buckley Dec., Ex. P) at 10 ("***Several below-market grants have been given*** to certain executive officers that vested 50% upon receipt ...")(emphasis added).

[24] *See* Buckley Dec., Exs. C-N (Forms 4, and one Form 3, identifying all of the options as NSOs). In the Opposition, plaintiffs assert, without any support whatsoever, that "the backdated stock options at issue are Incentive Stock Options ...." Opposition at 20 n.13. That assertion is patently false, as demonstrated by Exhibits C-N attached to the Buckley Declaration. Under the demand futility standard, "conclusory allegations of fact ... not supported by allegations of specific fact ***may not be taken as true***." *Levine v. Smith*, 591 A.2d 194, 207 (Del. 1991)(emphasis added).

[25] In fact, it is clear that the NSOs received by F5's outside Directors pursuant to the challenged grants could not have been granted pursuant to F5's 1996 or 2000 Stock Option Plans, because those plans explicitly exclude non-employee directors. *See* 1996 Stock Option Plan (Keehnel Dec., Ex. H) at 2 (p. 37) ("Non-Qualified Stock Options may be granted to Employees and to such other persons other than directors who are not Employees ..."); 2000 Employee Equity Incentive Plan (Keehnel Dec., Ex. K) at 1 (p. 70) ("[N]o individual who is an Officer or Director of the Company may be granted a Stock Award under the Plan"). Thus, there is at least a 50/50 chance that any NSO at issue here was granted under the 1998 Plan, and plaintiffs allege no particularized contrary facts. And F5's public filings expressly identify certain of the challenged options as having been issued pursuant to the 1998 Plan. *See* Buckley Dec. ¶ 18, Ex. Q.

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"backdated" options. All of those claims are based on a fundamentally flawed premise: that plaintiffs have adequately pled that any "backdating" occurred at F5. But plaintiffs have not established that any "backdating" occurred; they have merely graphed stock price movements and drawn unwarranted (and easily rebuttable) conclusions that F5's Directors committed fraud. If no fraud occurred in connection with the option grants, then F5's Directors' involvement in allegedly receiving or approving option grants cannot possibly establish demand futility.

In *CNET*, the Court analyzed a complaint virtually identical in approach, content, and tone to the Complaint at issue here (and drafted by the same counsel). The *CNET* complaint contained the same laundry list of "suspect" grants, the same parade of charts purporting to illustrate "wildly improbable" grant activity, and the same generic set of assertions about the CNET board's inability to exercise independent judgment in assessing a demand. Just as here, the *CNET* plaintiffs claimed that demand was futile because the director defendants had received and granted "backdated" options, and approved or issued misleading proxies and financial statements (as a result of their roles on the board or compensation and audit committees). *CNET*, 2007 WL 1089690 at *15-19. Despite being willing to draw an inference that three of the CNET grants *were* backdated, the *CNET* Court nevertheless found that demand was not futile and dismissed the derivative claims. F5 will not repeat the *CNET* analysis here, but respectfully submits that this Court should reach the same result. Nor will F5 repeat its detailed arguments in the Motion explaining why merely alleging that F5's Directors served on the Board, or participated on committees, cannot possibly satisfy plaintiffs' heightened burden to establish demand futility. *See* Motion at 28-33. Even if plaintiffs could clear their threshold hurdle of properly alleging that "backdating" occurred, they have not alleged, with particularity or otherwise, ***any*** link between any improper conduct and any particular F5 Director.[26]

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[26] Amusingly, plaintiffs attempt to avoid the impact of this Court's recent ruling in *In re Cray Inc. Deriv. Litig.*, 431 F. Supp. 2d 1114 (W.D. Wash. 2006), by pointing out that F5 has "only identif[ied] a single paragraph of plaintiffs' 210-paragraph Complaint in common with the facts in *Cray*." Opposition at 27:16. That "single paragraph" (¶ 154) goes on for two full pages of the Complaint, and comprises nine lettered subparts that summarize all of plaintiffs' demand futility allegations. Those allegations — virtually identical to plaintiffs' allegations here — are the allegations that Judge Zilly found to be inadequate to establish demand futility in *Cray*. *Id.* at 1121 n.5. Indeed, *Cray* and *CNET* provide a compelling roadmap for the dismissal of plaintiffs' claims here.

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D. <u>Plaintiffs' § 14(a) Claims Are Subject To The Demand Requirement</u>.

Plaintiffs argue that demand was not required with respect to their § 14(a) claim based on allegedly misleading proxy statements. Opposition at 29. As an initial matter, plaintiffs' § 14(a) claim suffers from the same fatal flaw as plaintiffs' other claims: the proxy statements were only arguably "false" if F5 engaged in "backdating," a predicate that plaintiffs have failed to adequately plead. More to the point, plaintiffs are simply wrong on the law. Plaintiffs cite only <u>one</u> on-point (though non-binding) case, *Vides v. Amelio*, 265 F. Supp. 2d 273 (S.D.N.Y. 2003), for the proposition that no demand is required for a derivative § 14(a) claim.[27] But the same court that erroneously decided *Vides* has since repeatedly acknowledged that a § 14(a) claim, like any other claim, cannot proceed derivatively unless demand has either been made or excused. *See, e.g., St. Clair Shores Gen. Emp. Ret. Sys. v. Eibeler, Case No. 06 CIV 688*, 2006 WL 2849783, *4-6 (S.D.N.Y. Oct. 4, 2006)(specifically disavowing *Vides*: "While acknowledging the existence of this controversy, the Court is not persuaded that Section 14(a) claims should be treated as a special species of derivative claim not subject to the demand requirement and business judgment rule"); *In re IAC/Interactivecorp Sec. Litig., Case No. 04 Civ. 7447*, --- F. Supp. 2d ---, 2007 WL 853021, *28 n.17 (S.D.N.Y. Mar. 21, 2007)(same). Other courts that have squarely addressed this issue have affirmed the same principle, including, most recently, the *CNET* Court. 2007 WL 1089690 at *19 ("***The weight of the authority*** supports requiring plaintiffs to make a demand or plead that demand was futile in alleging a claim under Section 14(a)")(emphasis added); *see also Virginia M. Damon Trust v. North Country Fin. Corp.*, 325 F. Supp. 2d 817, 818-21 (W.D. Mich. 2004)(same); *Shields on Behalf of Sundstrand Corp. v. Erickson*, 710 F. Supp. 686, 692-93 (N.D. Ill. 1989)(same).

As virtually every other court has recognized, the *Vides* reasoning is illogical. There is nothing unique about a § 14(a) claim that changes the fundamental principle that a shareholder may not pursue a claim on the corporation's behalf without satisfying the demand requirements.

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[27] The two other cases that plaintiffs cite in support of their position are wholly inapposite. *In re Tri-Star Pictures, Inc. Litig.*, 1990 Del. Ch. LEXIS 80, *25 (Del. Ch. June 14, 1990), addressed a <u>direct</u> § 14(a) claim, not a derivative claim, and merely noted that direct proxy violation claims do not logically implicate the business judgment rule because the issue is what information the <u>shareholder</u> received. Plaintiffs' § 14(a) is asserted derivatively, not directly. *In re Anderson, Clayton S'holders' Litig.*, 519 A.2d 669, 675 (Del. Ch. 1986), stands for the same proposition and did not involve a § 14(a) claim, any derivative claims, or any discussion of demand futility.

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E. Appointment Of The Special Committee Did Not Excuse Demand.

As a last gasp attempt to save their derivative claims, plaintiffs argue that F5's pre-suit appointment of a Special Committee to investigate options issues constitutes a concession that demand on the Board was excused. Opposition at 29-31. This argument is based on a distortion of the facts and a misreading of the law.[28] Unlike the facts here, all of the cases cited by plaintiffs involved special litigation committees that were given full power and authority to not only investigate, but to actually ***approve a course of action*** in response to shareholder demands or claims. In *Abbey v. Computer & Comm. Tech. Corp.*, 457 A.2d 368 (Del. Ch. 1983), the primary case on which plaintiffs rely, in response to a shareholder demand the board formed a special litigation committee, consisting of a single independent outside director, with binding authority to investigate the demand and determine whether to pursue litigation. *Id.* at 370-73. Because the board had divested itself of any power to make a decision regarding a lawsuit, the Court found that plaintiff's demand futility allegations were likely justified and allowed a derivative suit to proceed (before the committee had completed its investigation). *Id.* at 373. But the Court expressly distinguished a situation where a board "***merely*** appointed a committee ***to investigate the allegations and to report back*** to the board for whatever action the board might choose to take on the merits of the charges ...." *Id.* at 374 (emphasis added). And plaintiffs' other cases stand for the same inapplicable proposition. *See Peller v. Southern Co.*, 911 F.2d 1532, 1537 (11th Cir. 1990)(appointment, post-suit but before motion to dismiss, of special litigation committee with complete authority to evaluate and pursue litigation excuses demand); *In re FirstEnergy S'holder Deriv. Litig.*, 320 F. Supp. 2d 621, 626-27 (N.D. Ohio 2004)(delegation to special committee of complete authority to investigate and determine whether to pursue litigation concedes demand). That is not our case.

Abbey expressly recognizes that appointing a special committee simply to investigate an issue and make recommendations does ***not*** concede demand futility. That ***is*** our case — the F5

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[28] Plaintiffs attempt to cloud the issues by noting that one of the final Special Committee members, Deborah Bevier, did not join F5's Board until after this litigation was commenced. Opposition at 7. But the two important facts are (1) that the Special Committee was <u>formed</u> two weeks <u>before</u> the lawsuit commenced, and (2) it was tasked solely with investigating the Company's historical option grant practices. May 22, 2006 Press Release (Keehnel Dec., Ex. A).

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Special Committee's mandate (established before this suit was filed) was exclusively to investigate option grant issues and make recommendations to the Board. *See also In re Merck & Co., Inc., MDL Case No. 1658*, 2006 WL 1228595, *5-7 (D.N.J. May 5, 2006) (delegation of investigatory and advisory authority to special committee does not concede demand futility).[29]

Plaintiffs' Special Committee argument has far-reaching implications. There is an obvious public policy interest in having corporations police themselves and work diligently to uncover internal wrongdoing or errors. It will certainly undermine a corporation's incentive to appoint a special committee to conduct a thorough independent investigation if doing so will automatically remove from the Board's hands any authority to act on the results. Here, F5 acted voluntarily and promptly to examine its internal practices and procedures, and took significant steps to correct the deficiencies that its investigation uncovered. F5 should be applauded, not penalized, for undertaking those efforts.

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For the foregoing reasons, and those set forth in F5's Motion, the Court should dismiss the Complaint because plaintiffs have not adequately pled that demand on F5's Board would have been futile. Dismissal should be with prejudice because, as the *CNET* Court noted, plaintiffs had ample time to file this iteration of the Complaint and "every incentive to plead their best case." 2007 WL 1089690 at *20. Moreover, no amendment can cure the fundamental and fatal deficiencies in plaintiffs' "backdating" theories, which doom all of plaintiffs' derivative claims.

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[29] Plaintiffs are not even correct that delegating complete authority to a special litigation committee necessarily excuses demand. *See Spiegel v. Buntrock*, 571 A.2d 767, 777 (Del. Ch. 1990) ("[T]he decision of a board of directors to appoint a special litigation committee, with a delegation of complete authority to act on a demand, is not, *in all instances*, an acknowledgement that demand was excused and *ergo* that a shareholder's lawsuit was properly initiated as a derivative action")(emphasis in original); *Seminaris v. Landa*, 662 A.2d 1350, 1353 (Del. Ch. 1995)("To demonstrate ... demand futility, plaintiff must allege particularized facts to support a factual determination that the board ***intended*** to concede demand .... [A] disinterested board of directors does not waive its right to control derivative litigation merely by delegating that control to a special committee")(emphasis added).

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RESPECTFULLY SUBMITTED this 2nd day of May, 2007.

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CERTIFICATE OF SERVICE

I hereby certify that on this 2nd day of May, 2007, I caused the foregoing to be electronically filed with the Clerk of the Court using the CM/ECF System which will send notification of such filing to the following:

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THE HONORABLE ROBERT S. LASNIK

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

In re F5 NETWORKS, INC. DERIVATIVE LITIGATION.	**Master File No. C06-0794 RSL** **NOMINAL DEFENDANT F5 NETWORKS, INC.'S MOTION TO DISMISS AMENDED COMPLAINT FOR FAILURE TO MAKE DEMAND** **NOTE FOR MOTION CALENDAR: FRIDAY, FEBRUARY 15, 2008** **[ORAL ARGUMENT REQUESTED]**

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Nominal defendant F5 Networks, Inc. respectfully submits this Motion to dismiss Plaintiffs' Amended Consolidated Verified Shareholders Derivative Complaint ("Amended Complaint" or "AC") based on Plaintiffs' failure to make demand on F5's Board of Directors.

On August 6, 2007, the Court issued its Order Granting Nominal Defendant F5 Networks, Inc.'s Motion To Dismiss For Failure To Make Demand" (the "Order"). In the Order, the Court dismissed Plaintiffs' original Consolidated Verified Shareholders Derivative Complaint ("Complaint" or "Comp."), as a matter of law, because Plaintiffs failed to demonstrate that demand on F5's Board of Directors would have been "futile." The Court ruled that Plaintiffs had not established any inference that improper "backdating" of stock options occurred at F5. The Court gave Plaintiffs an opportunity to amend the Complaint in order to plead additional particularized facts, on a director-by-director basis, that demand on the Board would have been "futile," which requires a showing that (1) a majority of the F5 Directors were legally incapable of making litigation decisions for the Company (because they were interested or lacked independence), or (2) a specific stock option grant was not a proper exercise of the Board's business judgment. Order at 9-10; *see also In re Cray Inc. Deriv. Litig.*, 431 F. Supp. 2d 1114, 1121 (W.D. Wash. 2006).

The Amended Complaint contains no new ***facts*** that suggest — let alone that establish with the particularity required by FED. R. CIV. PROC. 23.1 — that demand on F5's Board would have been "futile." Partly in response to the Court's admonishments in the Order, Plaintiffs reduce to <u>nine</u> the number of F5 option grants that Plaintiffs claim were improperly "backdated" (in the seven-year period between 1999 and 2006). Plaintiffs also restate the same basic arguments this Court found lacking, and cite theories and authority this Court found unpersuasive, in analyzing the original Complaint. The Court's Order established the law of the case — there is no basis, on this Motion, for revisiting the standards that govern Plaintiffs' demand-futility burden. And Plaintiffs have alleged <u>no</u> additional material facts in the Amended Complaint to which those standards can be applied, or that would compel a result different than the result reached in the Order. Like the original Complaint, the Amended Complaint fails, as a matter of law, for these overarching reasons:

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- Plaintiffs attempt to create a general inference that illegal "backdating" (*i.e.*,***fraud*** – *see* Order at 12:1-2) occurred at F5 based on unexplained and flawed statistical metrics, erroneous "odds" theories, and biased and self-fulfilling "risks" or "patterns." Nothing in the Amended Complaint changes the fact (recognized by this Court) that Plaintiffs' arguments are pure conjecture. And conjecture can never be sufficient to establish fraud.
- Plaintiffs now identify only <u>three</u> grants in which at least three of the relevant F5 Directors (*i.e.*, those on the Board when the Complaint was filed, and whose "disinterest" impacts demand futility) received options. But none of those three grants raises any inference of "backdating" — indeed, each grant is subject to a variety of explanations more plausible than Plaintiffs' claim that the exercise price was the product of fraud. Consequently, as the Court already ruled in the Order, those three grants do not establish that any of the F5 Directors were "interested."
- As the Court also found in the Order, because Plaintiffs have not raised any generalized inference that "backdating" occurred at F5, it is not necessary to analyze each of the six remaining challenged grants individually. But when those six grants *are* analyzed, there is no reasonable inference to be drawn that any of the grants were improperly "backdated."
- Finally, Plaintiffs simply repeat their generic allegations that the F5 Directors served on Board committees, approved the Company's annual reports and financials, and issued Proxy Statements. In the Order, the Court correctly ruled (as Judge Zilly had previously ruled in *Cray*) that such allegations are patently inadequate to establish demand futility.

The Amended Complaint fails, as a matter of law, for the same reasons Plaintiffs' original Complaint failed. Plaintiffs have now had multiple opportunities to cure the fatal deficiencies in their claims and have been unable to do so. Consequently, the Amended Complaint should be dismissed without further leave to amend.

I. RELEVANT BACKGROUND

In its August 6, 2007 Order, the Court found the factual allegations in Plaintiffs' original Complaint insufficient, as a matter of law, to establish demand futility. Therefore, the central question on this Motion is whether the Amended Complaint contains new factual allegations that cure the deficiencies in the Complaint.[1] As discussed in the "Analysis" section below, it does not.

[1] For the Court's convenience, attached hereto as Appendix A is a chart of the "substantive" amendments in the Amended Complaint. While none of those amendments alter the Court's demand-futility analysis or save the Amended Complaint from dismissal, they represent more than semantic or organizational changes to the Complaint.

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In the original Complaint, Plaintiffs alleged that "11 of 25 stock option grants to F5's directors and top officers came at monthly lows in F5's share price." Comp. ¶ 2. That allegation was not factually accurate.[2] Now Plaintiffs allege that "12 of 26 stock option grants to F5's directors and top officers fell on the 2 most favorable dates, *i.e.*, the lowest (9) or second lowest (3) monthly closing price of F5's common stock." AC ¶ 2. But Plaintiffs do not contend that all 12 of those option grants were improperly "backdated." Instead, for the seven-year period between 1999 and 2006, Plaintiffs identify only the following nine grants as purportedly having been "backdated": (1) October 1, 1999; (2) February 10, 2000; (3) July 24, 2000; (4) January 1, 2001; (5) April 20, 2001; (6) April 27, 2001; (7) May 6, 2002; (8) May 8, 2003; and (9) April 30, 2004. AC ¶ 68.[3]

The six individual defendants who were F5 Directors at the time this action was initially commenced — *i.e.*, the only Directors who are relevant to the demand-futility inquiry — are (1) John McAdam, (2) Alan Higginson, (3) Karl Guelich, (4) Keith Grinstein, (5) Rich Malone, and (6) Gary Ames (referred to herein as the "relevant Directors"). Order at 11. In analyzing whether there was a reasonable doubt that the F5 Board was sufficiently "disinterested" to consider a demand, the Court noted that three or more of the relevant Directors received options in just five of the 12 grants Plaintiffs challenged in the original Complaint. Order at 12. In the Amended Complaint, Plaintiffs have retreated from two of those grants (those dated February 13, 2003 and April 29, 2004), so there are only three "key" grants in which at least three of the relevant Directors received options: (1) January 1, 2001; (2) April 20, 2001; and (3) May 6, 2002.

In addition to reducing the number of option grants they are challenging as "backdated," Plaintiffs have now admitted, in the Amended Complaint, two critical facts:

[2] The Court admonished Plaintiffs for mischaracterizing the relative monthly ranking of certain stock grants, and for relying on stock price charts that misleadingly depicted the timing of certain grants. *See* Order at 15 n.8; 18 n.10.

[3] These nine challenged option grants are a subset of the 12 purportedly "backdated" grants that Plaintiffs identified in the original Complaint. Plaintiffs are no longer challenging the grants made on March 16, 2001; February 13, 2003; and April 29, 2004. *Compare* AC ¶ 68 *with* Comp. ¶ 9. As discussed in more detail in Subsection II(C)(2) below, it is clear why Plaintiffs have retreated from at least the February 13, 2003 and April 29, 2004 grants: those grants were issued on the dates of F5's 2003 and 2004 Annual Meetings, pursuant to a pre-established and pre-***disclosed*** plan. It is impossible for those grants to have been "backdated" (despite Plaintiffs' insistence, in defending the original Complaint, that those grants were the product of a fraudulent "scheme").

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First, Plaintiffs now acknowledge (as they must) that the relevant F5 stock option plan (the 1998 Plan) expressly permits the Company to grant "in-the-money" stock options, *i.e.*, options priced below the fair market value of the stock on the date of the grant. Plaintiffs allege that "in the case of Non-Qualified Stock Options ("NSOs"), [the 1998 Stock Plan] allow[s] a grant to be discounted to as much as 50% of the fair market value of F5 stock on the date of the grant." AC ¶ 48 (emphasis omitted). The Court also recognized, and relied upon, the fact that the 1998 Plan authorizes F5 to grant below-market options. Order at 16.

Second, Plaintiffs now acknowledge (as they must) that "[a]ll of the grants at issue involve NSOs." AC ¶ 57. And Plaintiffs acknowledge further than any NSOs granted to non-employee Directors (*i.e.*, all of the relevant Directors except for McAdam) must have been issued pursuant to the 1998 Plan or the 1999 Plan. *Id.* (Thus, where there is no public information identifying which option plan authorized a particular challenged grant, there is a 50/50 chance the grant was authorized pursuant to the 1998 Plan, which specifically allows the Company to grant below-market options).

As discussed below, the remaining changes or additions in the Amended Complaint are merely a rehash of Plaintiffs' theories and arguments in support of the original Complaint, which this Court has already rejected.[4]

II. ANALYSIS

As discussed in the following subsections, the Amended Complaint must be dismissed with prejudice because Plaintiffs have failed to plead any new facts to support their position that demand on the F5 Board was "futile." Subsection II(A) addresses the fact that Plaintiffs still cling to the demand-futility standard set forth in *Maxim* and its progeny, a standard this Court has declined to adopt or follow. Subsection II(B) discusses and debunks Plaintiffs' generalized theories in support of the accusation that an illegal "backdating" scheme was in place at F5. Subsection II(C) analyzes

[4] In the briefing on F5's motion to dismiss the original Complaint, F5 provided a comprehensive recitation of the underlying facts. Because the issue on this Motion is whether Plaintiffs have alleged any new facts that cure the deficiencies in Plaintiffs' original allegations, in the interests of judicial economy F5 has chosen not to repeat those more detailed facts here. F5 incorporates its briefing on the prior motion to dismiss by reference, and respectfully requests that the Court refer to that briefing, as necessary, for the factual grounds underlying the Court's Order.

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the three "key" option grants (*i.e.*, those in which at least three of the relevant Directors received options) and explains why none of those grants was "backdated." Subsection II(D) analyzes why Plaintiffs have failed to adequately plead that any of the remaining six (non-"key") option grants were "backdated." Subsection II(E) briefly addresses Plaintiffs' allegations related to the F5 Directors' committee service or general corporate oversight, allegations the Court rejected in the Order as insufficient to establish demand futility. Finally, Subsection II(F) explains why Plaintiffs should not be given yet another opportunity to try to resurrect their lifeless arguments.

A. <u>Plaintiffs Continue To Rely On An Erroneous Demand-Futility Standard</u>.

In opposition to F5's motion to dismiss the original Complaint, Plaintiffs relied almost entirely on the demand-futility standards set forth in the Delaware Chancery Court's *Maxim* decision (*Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. Feb. 6, 2007)). It is clear from the Amended Complaint that Plaintiffs still believe that *Maxim* establishes the applicable standard: "As Chancellor Chandler articulated in his seminal decision on backdating in *Ryan*, a pattern of backdating is alleged with sufficient particularity when the dates, prices, recipients and the plan language violated are identified. *Ryan*, 918 A.2d at 355." AC ¶ 73.

This Court has already rejected the *Maxim* standard. Contrary to Plaintiffs' allegation, the Court ruled that it was ***not*** sufficient for Plaintiffs to merely identify a grant (*i.e.*, to allege the date, price, and recipients of the grant) and then summarily conclude that the grant violated F5's stock option plans — instead, for the five "key" grants (in which at least three of the relevant Directors received options), the Court engaged in a detailed, grant-specific analysis and concluded that Plaintiffs had failed to establish that those grants were "backdated." *See* Order at 13-19. For the remaining grants, the Court ruled that a "statistical analysis" — like the Merrill Lynch methodology, which Plaintiffs rely upon and which constituted the pivotal "fact" underpinning the *Maxim* decision — is inadequate, as a matter of law, "to plead particularized facts creating reasonable doubt that the option grants at issue were the product of a valid exercise of business judgment" (*i.e.*, were "backdated"). Order at 24:2-4. The Order is now the law of the case, and

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there is no reason or basis whatsoever to revisit or change the well-reasoned demand-futility standards the Court has established. *See United States v. Alexander*, 106 F.3d 874, 877 (9th Cir. 1997) (discussing the "law of the case" doctrine, and setting forth the grounds for departing from the law of the case, none of which apply here).[5]

There is no dispute that Plaintiffs bear an extremely heavy burden to establish demand futility, a burden even more onerous than that required to defeat a Rule 12(b)(6) motion. *Levine v. Smith*, 591 A.2d 194, 207 (Del. 1991). In addition, after briefing closed on F5's motion to dismiss the Complaint, the U.S. Supreme Court raised the bar a plaintiff must clear, under Rule 8(a), in order to adequately plead "a short and plain statement of the claim showing that the pleader is entitled to relief." FED. R. CIV. P. 8(a)(2). In *Bell Atlantic Corp. v. Twombly*, 127 S. Ct. 1955 (2007), the Supreme Court held that a plaintiff's "[f]actual allegations must be enough to raise a right to relief above the speculative level," and must "possess enough heft to show that the pleader is entitled to relief." *Id.* at 1965-66 (internal quotation omitted). After *Twombly*, a plaintiff must plead its claims "across the line from conceivable to ***plausible***." *Id.* at 1974 (emphasis added). As discussed below, many of Plaintiffs' arguments fail to satisfy even Rule 8(a) because they are simply not plausible.

B. Plaintiffs' Generalized "Backdating" Theories Are Inadequate As A Matter Of Law.

Plaintiffs allege no new ***facts***. The vast majority of the changes in the Amended Complaint are merely restatements of Plaintiffs' flawed "statistical" theories, which this Court already rejected.

[5] In the Amended Complaint, Plaintiffs also cite *Conrad v. Blank*, No. 2611-VCL, 2007 WL 2593540 (Del. Ch. Sept. 7, 2007) (unpublished) ("*Staples*"), which was decided shortly after the Court issued its Order. AC ¶ 65 n.2, 67. The unpublished *Staples* decision adds nothing to the demand-futility analysis because Vice Chancellor Lamb swallowed the *Maxim* reasoning whole. *Staples* stands for the same fundamentally erroneous position, stated in *Maxim*, that pure statistics are sufficient, at the demand-futility stage, to establish that ***fraud*** occurred. 2007 WL 2593540 at *8 n.30 ("It is sufficient that the plaintiff presented this court with the same statistical methods and similar aberrant option returns as those alleged in *Ryan*"). In contrast to this Court's approach, the *Staples* Court engaged in <u>no</u> grant-specific analysis; instead, as in *Maxim*, the Vice Chancellor simply <u>assumed</u> that improper dates had been deliberately chosen, and false information supplied, by the company. And the *Staples* Court specifically rejected the reasoning of *In re CNET Networks, Inc. S'holder Deriv. Litig.*, 483 F. Supp. 2d 947 (N.D. Cal. 2007), and *In re Linear Tech. Corp. Deriv. Litig.*, No. C-06-3290 MMC, 2006 WL 3533024 (N.D. Cal. Dec. 7, 2006), which this Court expressly relied upon. *See* Order at 12, 22. Finally, even if the *Staples* and *Maxim* standards had not already been rejected by this Court, the cases are easily distinguishable because the stock option plans at issue in those cases required <u>all</u> options to be granted at fair market value on the date of the grant. *Staples*, 2007 WL 2593540 at *8 ("There was also in *Ryan*, as there is here, a stockholder-approved option plan that required the exercise price of option grants to equal the market value of the common stock on the date of grant ..."). Here, in contrast, the Court has ruled that F5's 1998 Plan authorized below-market options.

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1. **Pure Odds**

Contrary to this Court's Order, Plaintiffs continue to imply that odds alone are sufficient to establish that the F5 Directors engaged in fraud. Order at 12:1-2 ("'[B]ackdating' is fraud"). Plaintiffs now allege that "the odds that 9 grants fall on the date with the lowest closing price and that 3 grants fall on the date with the second lowest closing price (out of 20 possible trading days) is 1 in 2,764,905. The odds that 9 grants fall on the date with the lowest closing price alone (out of 20 possible trading days) is 1 in 391,905." AC ¶ 72. Even if those allegations are true, Plaintiffs' odds theory proves nothing.

As an initial matter, Plaintiffs have not analyzed all of F5's option grants. Plaintiffs claim that "[b]etween 1999 and 2006, the Company disclosed 26 stock option grants." AC ¶ 71. In fact, during that period, there were at least *32* option grants to named defendants that were publicly disclosed (on Forms 3 or 4). In their "analysis," Plaintiffs failed to include the following six grants:

- A December 3, 1999 grant to defendant Grinstein at an exercise price of $118.50;
- A May 29, 2001 grant to defendant Coburn at an exercise price of $12.72;
- An August 13, 2001 grant to defendant Reinland at an exercise price of $12.73;
- A September 17, 2001 grant to defendant Rodriguez at an exercise price of $13.50;
- A July 18, 2003 grant to defendants Reinland and Rodriguez at an exercise price of $17.16;
- A July 16, 2004 grant to defendant Ames at an exercise price of $23.07.[6]

[6] These six grants were all publicly disclosed on Forms 3 and 4. *See* the Declaration of Brian D. Buckley, filed in support of this Motion ("Buckley Dec."), Exs. B-G, respectively. Some of the Forms require minor extrapolation to establish the grant date. For example, for the May 29, 2001 grant to Grinstein, the Form 3 (filed June 5, 2001) identifies the expiration date of the options as May 29, 2011, but does not specify the grant date. F5 disclosed that its grants generally expire after ten years. *See* 2001 Proxy Statement at 6 (Buckley Dec., Ex. H). Assuming an expiration period of ten years, the grant date would be May 29, 2001, and F5's closing stock price on that date was $12.72 (the exercise price identified on the Form 3). *See* Buckley Dec., Ex. A. (For the Court's ease of reference, Exhibit A is a chart of daily F5 stock prices covering the entire period challenged by Plaintiffs.) For the August 13, 2001 grant to Reinland, the Form 3 (filed October 25, 2005) identifies that the options were exercisable on August 13, 2002, and identifies further that the options were subject to a one-year vesting period. F5's stock price on August 13, 2001 was $12.73 (the exercise price identified on the Form 3). For the July 18, 2003 grant to Reinland and Rodriguez, the first tranche of the options was exercisable one month after the grant; the exercise date identified in the Forms 3 was August 18, 2003; and the stock price on July 18, 2003 (one month earlier) was $17.16 (the exercise price listed on the Forms 3). Note that Reinland and Rodriguez filed their Forms 3 on October 25, 2005, because they did not become "reporting officers" under Section 16 until October 2005, when they were promoted to senior finance positions. *See* October 25, 2005 Press Release (Buckley Dec., Ex. I) (issued the same day Reinland and Rodriguez filed their first Forms 3).

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The exercise prices of the six excluded grants coincided with the twelfth, eighteenth, fourth, twelfth, tenth, and fifth lowest stock prices, respectively, for the months of those grants. Thus, Plaintiffs' purported odds calculations are meaningless because, in fact, only 12 of *32* F5 option grants during the relevant period fell on one of the two most favorable monthly trading days.[7] Plaintiffs' odds allegations should be completely disregarded on that basis alone.[8]

As discussed at length in the Reply memorandum in support of F5's motion to dismiss the original Complaint, the odds of a particular company randomly achieving a particular grant-date dispersion is entirely the wrong inquiry — the right inquiry is the odds of ***some*** company achieving that particular grant-date dispersion. That is so because, in a vacuum, odds reveal nothing more than the likelihood that a specific event (*i.e.*, a particular pattern or dispersion of grant dates) will be achieved through the operation of random chance. Addressing the correct question, NERA Economic Consulting analyzed public companies' option grants nationwide and demonstrated that it is a virtual ***certainty*** that at least some of those many thousands of companies will, purely by chance, generate grant patterns that coincide with stock low-points and appear improbably "lucky."[9] In fact, it is reasonable to assume that at least one company in the U.S. could randomly hit the stock low-point for every grant it issues in a year. That is true because, as explained in the NERA study, the grant-dispersion patterns of all U.S. companies form the standard bell curve associated with random chance, which necessarily includes rare but inevitable "outliers" at either end of the curve.[10] Relying on odds alone, there is no way to determine whether a particular company that appears to

[7] The Court will recall that in oral argument on F5's motion to dismiss the original Complaint, Plaintiffs argued that "there are publicly disclosed grants by F5 on 32 different days and that grants on 10 of these days are backdated …." Order at 23:11-12. It appears that Plaintiffs knew the actual number of grants in the relevant period, but chose to understate that number in the Amended Complaint (perhaps because the other six grants did not occur at low points).

[8] Plaintiffs claim that the odds on which they rely were computed by RGL Forensic Accountants and Consultants. AC ¶ 72. Obviously, neither the Court nor F5 will have an opportunity to explore RGL's qualifications or test its conclusions in the context of this Motion. But it is immaterial whether Plaintiffs performed their own odds calculations or had an "expert" do it, because pure odds tell the Court nothing about whether "backdating" occurred at F5.

[9] *See* NERA Study, "Options Backdating: The Statistics of Luck" (March 2007) (Buckley Dec., Ex. J).

[10] NERA Study at 4. In fact, the grant dispersion bell curve skews slightly toward the "lucky" end of the curve, which is precisely what would be expected, given that companies have various (entirely appropriate and innocent) incentives to attempt to time their option grants for low points in the company's stock price (as discussed further below).

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have been unreasonably "lucky" with its option grants (as Plaintiffs suggest applies to F5) is simply that statistical outlier that is effectively ***certain*** to occur in any random distribution.

Thus, Plaintiffs' contention that F5's grant pattern is "wildly improbable" is simply immaterial to the demand futility inquiry. Winning the Mega Millions Lottery is "wildly improbable" — the odds of a particular person hitting the jackpot are 1 in 175,711,536[11] — yet people win routinely, without any suggestion they engaged in fraud. Moreover, if the Plaintiffs' calculations are correct, then the odds that 12 of 26 of a company's option grants will fall on the two ***least*** favorable dates (*i.e.*, the highest or second-highest monthly closing price) would be exactly the same (1 in 2,764,905), but neither Plaintiffs nor pundits have examined how many companies fit that "unlucky" profile. In short, the odds Plaintiffs attempt to rely on demonstrate only <u>one</u> fact: that F5's grant-dispersion pattern fell toward the "lucky" end, rather than the "unlucky" end, of a random distribution. That fact does not and cannot create any inference of fraud.

2. <u>"Risk" Indicators</u>

In the Amended Complaint, Plaintiffs identify certain indicators that purportedly create a "risk" that options have been "backdated." Plaintiffs allege: "According to *The Wall Street Journal*, academics who have studied backdating have noted that 'a pattern of sharp stock appreciation after grant dates is an indication of backdating; by chance alone, grants ought to be followed by a mixed bag of stock performance – some rises, some declines.'" AC ¶ 64. But it is precisely that "sample selection bias" that renders the Merrill Lynch report and its kin unreliable. The suggestion that "by chance alone, grants ought to be followed by a mixed bag of stock performance" is, at best, an

[11] *See* http://www.justlottery.com/us/games.html. If Plaintiffs are correct that the odds of 12 of 26 option grants randomly falling on the two most favorable dates in a month are 1 in 2,764,905, the odds of being a Mega Millions winner are over *60 times* more "wildly improbable." Indeed, Plaintiffs' statistics in the Amended Complaint lack even visceral appeal: if the odds of 9 out of 26 option grants randomly coinciding with the lowest monthly stock price are, in fact, 1 in 391,905, those odds do not appear "wildly improbable." (If the lottery odds were as favorable, we would all be playing. And we know those odds are erroneously negative because only 9 of *32* grants coincided with the lowest monthly stock price.) In the original Complaint, Plaintiffs claimed that the odds of F5's grant dispersion occurring randomly were "less than 1 in ***90 million***." Comp. ¶ 2 (emphasis added). Even at that much higher alleged figure, the Court rejected Plaintiffs' suggestion that F5's grants reflect an "astonishing multi-year pattern" indicating that "grants were repeatedly backdated." Order at 22. The Amended Complaint is based on precisely the same statistical "analysis;" it merely changes (and reduces) the odds numbers. As such, there is no reason for the Court to change its ruling.

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overstatement. That is true for companies whose option granting patterns fall within the center of the random distribution bell curve. It is, by definition, ***not*** true for companies whose grant dispersions fall toward either end of the bell curve — *i.e.*, stock performance following those companies' grants is not an evenly "mixed bag"; instead, it skews either "lucky" or "unlucky," depending on which end of the bell curve one chooses to focus on.[12] Merrill Lynch, CFRA, and other analysts hoping to fan the flames of scandal focused on the ostensibly "lucky" end of the distribution, and ignored the myriad companies whose grants appear unreasonably "*un*lucky." If one assumes, as Merrill Lynch and others (including Plaintiffs and the *Maxim* and *Staples* Courts) have done, that a pattern skewed toward positive post-grant stock performance is an indicator of fraudulent "backdating," then when one deliberately *seeks* companies that fit that pattern, it is preordained that those companies will be "at risk" of "backdating."[13] The incurable flaw in that approach is that such patterns not only can, but undeniably ***will***, occur purely as a result of chance.[14]

Plaintiffs also allege that "stock option grants are more likely backdated when they are discretionary and granted by a sporadic method. Accordingly, plaintiffs also reviewed each grant to determine whether or not it was granted in a sporadic fashion or on a fixed date pursuant to a non-discretionary stock option plan." AC ¶ 70. Plaintiffs' fundamental premise — that the grant date of

[12] Even the basic premise that F5's grant pattern was not a "mixed bag" is inaccurate. Less than half of the 26 grants that Plaintiffs identify fell on the two most favorable monthly dates. (And Plaintiffs ignored six additional grants, none of which fell on either of the two most favorable dates.) The remaining grants reflect a variety of monthly rankings, so F5's post-grant stock performance was, in fact, marked by "some rises, some declines." This "risk" indicator also depends entirely on how "stock performance" is defined. For example, Plaintiffs allege that defendant Amdahl received a grant on February 10, 2000 at a strike price of $89.50 (the lowest closing price for the month) (AC ¶ 76), but by March 31, 2000, F5's stock price was at $67.85; by June 30, 2000 the stock price was at $54.56; and by year-end the stock price was at $9.50 (stock performance that could only be described as negative). *See* Buckley Dec., Ex. A. In other words, "stock performance" varies depending on the "window" through which it is viewed. Moreover, the options granted to Amdahl on February 10, 2000 were subject to vesting requirements, with the first 17% of the options vesting in October 2000 and the remainder vesting in tranches over the following three years. *See* Buckley Dec., Ex. K (Amdahl Form 4). For options subject to vesting periods (as were most of the options in this case), a 20-day window for evaluating stock performance makes no sense.

[13] Along the same lines, Plaintiffs cite the Merrill Lynch report for the proposition that "[t]he most effective way to consistently capture low-price days for option grants is to wait until after a stock has risen, then backdate a grant to a day prior to that rise." AC ¶ 66. But that is merely the definition of "backdating" — the Merrill Lynch report might as well have stated that the easiest way to backdate is to backdate.

[14] *See* NERA Study at 3 (explaining why the "sample selection bias" in the *Wall Street Journal* and Merrill Lynch analyses necessarily distort, and render unreliable, the findings in those studies).

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an *ad hoc* option grant is more easily falsified — is both obvious and uncontroversial. But the premise breaks down in the application, because (as discussed further below) it is not always possible to determine from the basic grant data (*i.e.*, date, price, and recipients) if the grant was authorized under a non-discretionary plan. Moreover, as discussed in Section II(C)(2) below, in their "review of each grant," Plaintiffs failed to recognize at least one grant that was clearly issued under a non-discretionary and pre-disclosed plan.[15]

3. <u>Percentage Returns</u>

The Amended Complaint alleges that "Plaintiffs studied the 20-day returns following each of F5's 26 stock option grants to officers and directors between 1998 and 2006. Overall, plaintiffs' analysis revealed that, on average, between 1999 and 2006, defendants received a 788.6% return on their backdated stock option grants while shareholders received, on average, only a 19.9% return over the same time period – a disparity of 768.7% in favor of management." AC ¶ 68. Plaintiffs' "percentage return" theory — which Plaintiffs claim "supports an inference that several grants appear to be backdated," AC ¶ 68 (identifying the nine challenged grants) — is flawed for a variety of reasons.

<u>First</u>, Plaintiffs persist in focusing on the 20-day trading period following F5's grants, despite the fact that the vast majority of the grants at issue were publicly disclosed (*i.e.*, reported to the SEC on Forms 3 and 4) earlier than 20 trading days after the grant.[16] The Court already took notice of that fact, and ruled that it "renders the 20-day cumulative return analysis meaningless for

[15] In the Amended Complaint, Plaintiffs argue: "That a stock option grant might be issued pursuant to a non-discretionary fixed date plan only reduces, but does not eliminate, the likelihood that stock options were being backdated. For example, in a recent stock option backdating action against CNET Networks, Inc., the company was forced to re-price so-called non-discretionary fixed date grants and admit that those grants were not actually granted on the fixed-date required by the applicable stock option plan." AC ¶ 70 n.5. That argument is no more than a truism. If a company committed, under a non-discretionary plan, to grant options on a specific date and then admittedly violated the plan by granting the options on a different date, of course the options should be re-priced to reflect the correct date. In this case, however, it is undisputed that no F5 options had to be re-priced.

[16] In its Reply on the motion to dismiss Plaintiffs' original Complaint, F5 also discussed the fact that most of the options at issue in this case were subject to vesting requirements. Reply at 11-12. Although the Court found it unnecessary to address F5's vesting arguments (*see* Order at 13 n.6), vesting requirements further undermine Plaintiffs' 20-day percentage return arguments because any "value" the options accrued in the 20-day trading window following the grant was utterly illusory if the options were not exercisable until months or years later.

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these grants." Order at 23 n.12. It is difficult to understand why Plaintiffs would continue to place such substantial reliance on a metric that the Court has expressly rejected, and that cannot logically have any bearing on most of the grants at issue.

Second, the 20-day percentage return on options is purely a function of whether the grant price fell at or near a low-point in the stock. The percentage return, in and of itself, demonstrates nothing, because an entirely "innocent" grant (or one authorized by an established, non-discretionary plan) would also experience a positive percentage return if the grant happened to coincide with a stock price low. Thus, unless the mere fact that a grant coincided with a low-point in the stock price is, in and of itself, a sign of "backdating" (and, as discussed above, it clearly is not), a positive percentage return adds nothing to the demand-futility inquiry. Stated differently, the percentage return metric is inherently neutral because the same positive returns would occur regardless of whether the underlying conduct (selection of the grant date) was innocent or nefarious.

Third, it is not even clear what Plaintiffs' "percentage returns" purportedly measure. The 20-day percentage increase in the exercise price of an option is easy to calculate. Plaintiffs then claim to have "annualized" those 20-day returns, but do not explain what that means. Nor do Plaintiffs explain how they calculated "Annualized Shareholder Return," to which they compare the F5 option grants to demonstrate an alleged "disparity of 768.7% in favor of management." AC ¶ 68. Is the annualized return for shareholders based on a shareholder who owned F5 stock on January 1 and still held that stock on December 31? That baseline would be meaningless because it would ignore "in-and-out" trading, as well as the significant annual volatility in F5's stock price (which this Court recognized). *See* Order at 16. By the same token, "annualizing" a particular Director's percentage return during a 20-day trading window is completely artificial, because it assumes (i) that F5's stock will perform on an annual basis exactly as it did during the 20-day snapshot, and (ii) that the Director will be able to capture the theoretical return (in light of vesting requirements and actual stock performance). For example, regarding the February 10, 2000 grant to Amdahl, Plaintiffs allege that the "annualized 20-day return for this grant is 527%." AC ¶ 76. But Amdahl's

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options (priced at ***$89.50***) were subject to three-year vesting, and F5's stock price on December 29, 2000 was ***$9.50*** — thus, Amdahl's annualized return was not 527%, it was ***0%***. Similarly, Plaintiffs claim that F5 shareholders lost money (*i.e.*, "received a -50% return") in 1999. But the stock price on the June 4, 1999 date of F5's initial public offering ("IPO") was ***$14.87***, and F5's stock on December 31, 1999 closed at ***$114.00***. Thus, shareholders who purchased F5 stock in the IPO and held it for just a few months certainly did not lose money.[17]

The various questions raised by Plaintiffs' "percentage return" metric point up this reality: statistics can be twisted to support virtually any conclusion. At oral argument on F5's first dismissal motion, the Court expressed reasonable and appropriate skepticism that statistical "analyses" can or should play any role in assessing whether ***fraud*** occurred (which is what the "backdating" inquiry requires). And in the Order, the Court correctly rejected Plaintiffs' reliance on number-shuffling to meet their particularity burden under Rule 23.1. Order at 22-23. The Amended Complaint adds ***no*** factual particularity, and Plaintiffs' slightly revised "statistical" models in the Amended Complaint are no more understandable or persuasive than before.

4. Reporting Periods

The Amended Complaint alleges: "The studies noted that prior to the enactment of the Sarbanes-Oxley Act ('SOX') in 2002, which requires companies to disclose stock option grants within two business days of the grant, stock option backdating was difficult, if not impossible, to detect." AC ¶ 61. Why would that be so? Plaintiffs' "backdating" analysis relies entirely on identifying grant dates and then reviewing stock price movements following those grant dates. The date on which a grant was ultimately reported to the SEC plays no part whatsoever in Plaintiffs' analysis — in fact, Plaintiffs persist in *ignoring* the actual reporting dates of F5's grants because that reporting undermines Plaintiffs' "backdating" metrics.

[17] Moreover, like their odds calculations, Plaintiffs' aggregate percentage return calculations for the F5 grants are meaningless because Plaintiffs excluded six option grants. None of those grants fell on either of the two most favorable monthly trading dates, so including those grants in the calculation would almost certainly decrease the aggregate percentage returns on which Plaintiffs rely.

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In addition, Plaintiffs allege: "Another indicia of backdating is a long period of time between the purported grant date and the date the grant was disclosed to the SEC. Thus, plaintiffs also reviewed the amount of time between the purported stock option grant date and disclosure of the grants to the SEC via Forms 3, 4 or 5. Grants that are not disclosed to the SEC in a timely fashion are more likely backdated. ... For the stock option grants plaintiffs allege were backdated after SOX was implemented, plaintiffs reviewed the price movement in the lag time between the grant date and the date defendants disclosed the grant to the SEC." AC ¶ 69. But Plaintiffs' theory is grounded in a fundamental fallacy: that the company and/or its board are responsible for reporting option grants to the SEC. The burden is entirely on the grant ***recipient***, not the company, to report options to the SEC using Forms 3, 4, and 5. *See* 15 U.S.C. § 78p(a); *see also* www.sec.gov/answers/form345.htm.

Plaintiffs' misguided argument is exemplified by their challenge to the July 24, 2000 option grants to McAdam. *See* AC ¶ 78-79. Plaintiffs allege that McAdam received two grants on July 24, 2000, and reported one of those grants to the SEC on August 2, 2000, and reported the other on October 4, 2000. Plaintiffs then claim: "This delay alone is an indication of backdating. But the fact that ***defendants*** split the reporting of two grants that were purportedly granted to McAdam on the same day provides an even stronger inference that these option grants were backdated." AC ¶ 79 (emphasis added). Contrary to Plaintiffs' allegation, the defendants (*i.e.*, the relevant Directors) did not "split the reporting" of these grants — the recipient alone is responsible for reporting. Thus, unless there is some evidence that the recipient of the grant at issue was also involved in the approval of the grant, the recipient's delay in reporting the grant cannot possibly be evidence that the grant was "backdated."[18]

[18] Nothing in this discussion should be read to give credence to the concept that a grant recipient's delay in reporting an option grant is evidence that the entire Board or Compensation Committee was engaged in "backdating." Prior to the enactment of Sarbanes-Oxley in 2002, the law permitted recipients to wait as long as a year to report; in that context, a reporting delay of even a few months is more plausibly the result of inattention, rather than fraud. And the three "key" grants Plaintiffs challenge (January 1, 2001; April 20, 2001; May 6, 2002) all occurred prior to the August 2002 effective date of Sarbanes-Oxley, so Plaintiffs' "reporting period" theory is largely irrelevant.

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5. Stock Option Plan Restrictions

As discussed above, Plaintiffs now acknowledge that F5's 1998 Plan authorized the Company to grant below-market options. AC ¶ 48; *see also* Order at 16. In an attempt to side-step the impact of that authorization, Plaintiffs make the following peculiar argument: "While the Board of Directors is allowed to grant NSOs under the 1998 Plan at no less than 50% of fair market value, it is not allowed to retroactively choose the grant date. Thus, the Board is not permitted to look back in time to grant options on a date the exercise price happened to fall within 50% of the fair market value of F5 stock on the date the grant is actually issued. Rather, the shareholder-approved plan expressly states that a grant can only be made at 100% (or not less than 50%) of the fair market value of F5 stock ***on the date of the grant***." AC ¶ 48 n.1 (emphasis in original). Semantics aside, Plaintiffs admit that the 1998 Plan permits F5 to (i) decide to grant options on a particular date, (ii) determine the fair market value of F5's stock on that date, and then (iii) price the options at between 50% and 100% of that fair market value.

Given the express authorization to grant below-market options, what possible difference could it make if F5 chooses the exercise price for those options by arbitrarily selecting a price or by using a historical price that is not less than 50% of the fair market value on the grant date? Plaintiffs' theory, if valid, would even prevent F5 from arbitrarily selecting an exercise price that happened to match an historical stock price — the Company would be required to affirmatively review its historical stock prices and select a price that was historically unrepresented. The absurdity of that position should be evident.

6. Alleged Proxy Statement Representations

Finally, without citation to any documents or supporting facts, Plaintiffs allege: "Without exception, in each proxy statement issued by F5 during the relevant period, the F5 directors represented to shareholders that option grants to executives and directors during the preceding year had been made at fair market value on the date the Board of Directors purportedly issued the grant and would continue to be made to such executives and directors at fair market value during the

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current year." AC ¶ 48. Throughout their discussion of the F5 Proxy Statements, Plaintiffs then allege: "Moreover, the NSOs granted to directors under the 1998 Plan were all disclosed in proxy statements as having been granted at 100% of fair market value and not at discounted prices. *See* 2001 Proxy at 4; 2002 Proxy at 2; 2004 Proxy at 5." AC ¶¶ 104, 107, 114, 119, 124, 128.

F5's 2001, 2002, and 2004 Proxy Statements — the Proxy Statements that Plaintiffs cite in support of the allegation that F5 represented that <u>all</u> NSOs were granted at fair market value — are attached as Exhibits H, L, and M to the Buckley Declaration. A review of those Proxy Statements (including the specific pages cited by Plaintiffs) does <u>not</u> support Plaintiffs' allegations. Although the Proxy Statements do identify certain grants made pursuant to the 1998 Plan, none of the Proxy Statements contains a representation that all grants under the 1998 Plan were at fair market value. For example, the 2002 Proxy Statement discloses the following:

> In January 2001, each of Messrs. Higginson, Guelich and Grinstein was granted an option to purchase 7,500 shares of Common Stock at an exercise price of $9.50 per share under the Company's 1998 Equity Incentive Plan (the "1998 Plan"). In April 2001, each of Messrs. Higginson, Guelich and Grinstein was granted options to purchase 15,000 shares of Common Stock at an exercise price of $8.10 per share under the 1998 Plan. All options granted under the 1998 Plan were fully vested and exercisable on the date of grant.

2002 Proxy (Buckley Dec., Ex. L) at 2 (the same page cited by Plaintiffs). The Proxy Statement does <u>not</u> represent that the options granted under the 1998 Plan were at fair market value, only that those options were ***exercisable*** (*i.e.*, fully vested) on the grant date.[19] And again, as Plaintiffs admit and this Court already found, the 1998 Plan expressly permits options to be granted at any exercise price not lower than 50% of fair market value.

Plaintiffs also allege that the 2000 Proxy Statement contained the following statement: "Eligible non-employee directors receive automatic option grants under the Company's 1999 Non-Employee Directors' Option Plan ***with an exercise price equal to the fair market value of the***

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[19] Plaintiffs do not even accurately allege when the Proxy Statements were filed. They claim the 2001 Proxy Statement was filed on March 20, 2001 (AC ¶ 105), but it was filed on March 7, 2001. Buckley Dec., Ex. H. They claim the 2002 Proxy Statement was filed on January 28, 2002 (AC ¶ 107), but it was filed on January 17, 2002. Buckley Dec., Ex. L. And they claim the 2004 Proxy Statement was filed on March 18, 2004, but it was filed on March 11, 2004. Buckley Dec., Ex. M.

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Common Stock on the date of grant." AC ¶ 100 (emphasis in original). According to Plaintiffs, that "statement was false and misleading because defendants, including Guelich and Higginson who sat on the Compensation Committee and made recommendations regarding stock options to the entire Board, approved stock option grants with an exercise price less than fair market value on the actual date the grant was made." AC ¶ 101. Plaintiffs' assertion is patently baseless. First, the allegedly "false and misleading" statement refers only to options granted under the ***1999*** Plan, but there is no dispute that the Company also granted many options under the ***1998*** Plan, which authorized below-market grants. Second, the very same Proxy Statement specifically disclosed that "***[s]everal below-market grants have been given*** to certain executive officers ...." 2000 Proxy Statement (Buckley Dec., Ex. N) at 10 (emphasis added).[20] In short, Plaintiffs simply have not, and cannot, allege that F5 ever misrepresented in the Proxy Statements (or anywhere else) its option granting practices.

C. The Three "Key" Grants Were Not "Backdated."

In its Order, the Court specifically analyzed five option grants: those grants in which at least three of the relevant Directors received options. The Court's rationale was that Directors who received "backdated" options would be *per se* "interested," and disqualified from impartially considering a demand related to the grant of those options. *See* Order at 12-13.[21] For reasons that will become apparent, Plaintiffs have abandoned their challenge to two of those five grants

[20] In addition, in its other Proxy Statements, F5 disclosed that its stock options "are ***typically*** granted at the current market value." *See, e.g.*, 2002 Proxy Statement (Buckley Dec., Ex. L) at 11 (emphasis added). Obviously, implicit in that statement is that the Company's options are not ***always*** granted at current market value. It is beyond legitimate dispute that F5 consistently disclosed that it granted some below-market options.

[21] F5 respectfully disagrees with that basic holding. A Director who merely received a "backdated" option, but did not play any role in approving the option grant, would not face any likelihood (let alone a substantial likelihood) of liability in connection with that grant. The Director would stand in no different position — and would receive no different benefit — than any other F5 executive or employee who received "backdated" options but who was not involved in the granting decision. Nor would the Director face any different potential *detriment*, because if he was not involved in the "backdating" fraud, the Director would be no more subject to disgorgement of the option than would the receptionist who received options in the same grant. As the Court recognized, the fundamental issue is whether the Director engaged in "***self-dealing***" behavior, a concern that is absent if the Director merely received, but did not approve, the grant. Order at 13. Thus, unless Plaintiffs can connect a particular Director to the decision to "backdate" a particular grant of options to himself, there is no reason to automatically find that Director incapable of impartially considering a demand.

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(the February 12, 2003 and April 29, 2004 grants). And as the Court already ruled, there is no reasonable inference to be drawn that the remaining three grants (January 1, 2001; April 20, 2001; and May 6, 2002) were "backdated." Plaintiffs have added nothing (in the way of new facts or argument) to the Amended Complaint that changes that analysis.

1. <u>January 1, 2001 Grant</u>

Plaintiffs allege that, on January 1, 2001, options were granted to F5 executives and Directors, including McAdam, Guelich, Grinstein, and Higginson. AC ¶ 80. The exercise price of those options was $9.50, which was the lowest closing price of the month for F5's stock. *Id.*[22] What Plaintiffs have *not* alleged is any reason to infer that the price was the result of fraud.

F5 disclosed the January 2001 grant. In the 2001 Proxy Statement, the Company stated: "Beginning in 2001, ... all non-employee directors who serve on a board committee and who have been on the board for at least six months will receive 7,500 options in January and 7,500 options the following June of each year. These options will be fully vested upon grant, and will have an exercise price equal to the closing price of the Company stock on the grant date." 2001 Proxy Statement (Buckley Dec., Ex. H) at 2. In its 2002 Proxy Statement, F5 disclosed: "In January 2001, each of Messrs. Higginson, Guelich, and Grinstein was granted an option to purchase 7,500 shares of Common Stock at an exercise price of $9.50 per share under the Company's 1998 Equity Incentive Plan (the "1998 Plan")." 2002 Proxy Statement (Buckley Dec., Ex. L) at 2. In other words, the January 1, 2001 grant to the Directors was the product of a non-discretionary plan.

The SEC has recognized that "[s]ome companies have awarded options with provisions designed to protect an employee from immediate declines in the stock price. Typically, these awards do not have a stated exercise price at the award approval date but instead include a ***formula*** for

[22] In the Order, the Court found that Directors Higginson, Guelich, and Grinstein disclosed their options to the SEC on March 5, 2001, at which point F5's stock price was $6.81. Order at 13-14. The Court noted that there were more advantageous stock prices between January 1, 2001 and March 5, 2001, which the Directors could have chosen if they were, in fact, "backdating." It must be noted, however, that the January 1, 2001 grant was first disclosed to the SEC on February 8, 2001 (AC ¶ 81), when F5's stock price was $12.81, and the stock did not trade lower than $9.50 in the period between January 1 and February 8, 2001. Thus, the reporting period for this grant is not particularly relevant, but, as discussed below, there are many other indicia that the January 1, 2001 grant was not "backdated."

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establishing the exercise price. For example, ***an award may establish an exercise price as the lowest market price of the company's stock over a 30-day period beginning with the award approval date.***" *See* September 19, 2006 Guidance Letter from SEC Chief Accountant ("SEC Guidance Letter") at 7 (emphasis added).[23] As the SEC Chief Accountant has acknowledged, there is absolutely nothing wrong with granting options pursuant to a non-discretionary plan that uses a formula to establish the strike price. That approach simply requires the company to use variable accounting until the contingency in the formula (*i.e.*, which day of the month will have the lowest stock price and, therefore, constitute the measurement date) is determined. *Id.*

The January 1, 2001 grant bears all the characteristics of a grant priced pursuant to a formula. The Company adopted a non-discretionary plan to grant a specified number of options to non-employee Directors in the month of January. 2001 Proxy Statement (Buckley Dec., Ex. H) at 2. The January 2001 grant immediately followed a year in which F5's stock price had plummeted, from ***$119.50*** on January 3, 2000 to ***$9.50*** on December 29, 2000. It is certainly reasonable to assume that F5 would have desired, with its first grant in the new year, to protect the grant recipients from further "immediate declines in the stock price." SEC Guidance Letter at 7. The method (recognized and approved by the SEC) for providing such protection is to utilize a formula that "establish[es] an exercise price as the lowest market price of the company's stock over a 30-day period beginning with the award approval date." *Id.* That F5 had adopted a similar formula for the January 2001 grant is supported by the exercise price of the January 1, 2001 grant. January 1, 2001 was <u>not</u> a trading day (presumably because it was New Year's Day). Consequently, the market price of F5's stock on January 1, 2001 defaulted to the last trading day, December 28, 2000, when F5's stock price was $9.50. But because the Company's non-discretionary plan required the grant to occur in January, and because a formula ostensibly required the grant to be priced at the lowest price for January, the official grant date was January 1, 2001. If the grant had been discretionary,

[23] *See* Buckley Dec., Ex. O. The SEC Guidance Letter is also available on the SEC's website at <u>http://www.sec.gov/info/accountants/staffletters.shtml</u>.

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the Company would simply have identified the grant date as December 28, 2001, or would have granted instead on January 2, 2001, the first trading day of the month.

Committing, in advance, to use the lowest date in a period as the measurement date for an option grant involves no "backdating" and is not fraudulent. The options are merely granted subject to a future contingency (which carries certain accounting implications). The most plausible inference to be drawn from the undisputed facts is that the January 1, 2001 grant was priced subject to a formula. It is Plaintiffs' burden to overcome that inference with ***particularized facts*** that support fraud. Instead, Plaintiffs allege ***no*** facts that suggest "backdating," but rely exclusively on the coincidence of the January 1, 2001 grant occurring at a monthly low. As discussed at length above, that "statistical" approach is inadequate, as a matter of law, to establish fraud.

Indeed, even if the facts did not strongly suggest that the January 1, 2001 grant was priced pursuant to a non-discretionary formula, Plaintiffs' challenge to that grant would *still* fail under the basic principles already analyzed and adopted by this Court. There were only 21 trading days in January 2001; consequently, the odds of F5 randomly granting at the lowest monthly stock price were 1 in 21. Those are hardly the "wildly improbable" odds on which Plaintiffs' entire "backdating" theory is premised. *See* Order at 16. Moreover, the $9.50 price was the lowest for January 2001, but not nearly the lowest price for the general period — as the Court recognized, F5's stock was trading well below $9.50 just a short time later. Order at 14. And the January 2001 grant followed a sustained and substantial slide in the stock price, from $58.31 on September 1, 2000 to just $9.50 at year-end. It is not just plausible but likely that F5 deliberately sought to grant options at a low-point in the stock price.[24] Such a grant serves the dual goals of (i) making the options

[24] In fact, even the *Wall Street Journal* article on which Plaintiffs rely so heavily acknowledged this very dynamic. *See The Wall Street Journal*, "The Perfect Payday" (March 18, 2006) at 3 ("It's also possible companies sometimes award options after their stock has taken a fall and seems to them to be undervalued. In point of fact, the companies can't possibly know what the stock will do next, but that doesn't mean they might not feel confident enough about a recovery to think they are hitting a favorable time to grant options"). *See also* NERA Study at 2, 4 (recognizing that companies rationally grant options when their stock is perceived to be undervalued, and that, as would be expected, such deliberate granting behavior causes the random distribution of companies' grant patterns to skew slightly toward the "lucky" end of the bell curve).

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potentially more valuable for the recipients (whom the Company is seeking to either encourage or reward), and (ii) giving the option recipients incentive to work together to increase the stock's value. It is particularly plausible that F5 would make such a grant at the beginning of a new year, a logical time for the Company to redouble its efforts to improve performance.

All of the facts logically suggest that the January 1, 2001 grant was the product of factors other than deliberate "backdating." Plaintiffs have nothing to counter that logical conclusion but the mere fact that the grant coincided with a monthly low-point in F5's stock. That is clearly not the factual particularity that Rule 23.1 requires.

2. April 20, 2001 Grant

Plaintiffs allege that 45,000 options were granted to Higginson, Guelich, and Grinstein on April 20, 2001, at an exercise price of $8.10. AC ¶ 82. Plaintiffs now acknowledge that the grant price was one of the ***highest*** for the month of April 2001.[25] Yet, Plaintiffs contend that the April 20, 2001 grant was "backdated" purely because "the price of F5 stock rose by 37.8% to $11.16 per share within 20 trading days of the grant." *Id.* Plaintiffs' position is demonstrably false, and is also a stark example of the baseless (even frivolous) nature of Plaintiffs' theories.

F5 publicly disclosed the following option grant practice: "Beginning in fiscal year end 2001, all non-employee directors who also serve on a Board committee receive options to purchase 15,000 shares of Common Stock ***on the day of the Company's annual meeting***." 2004 Proxy Statement (Buckley Dec., Ex. M) at 4 (emphasis added). F5 disclosed further that Higginson, Guelich, and Grinstein each received 15,000 options (for a total of 45,000) in April 2001 at an exercise price of $8.10. *Id.* at 5; *see also* 2002 Proxy Statement (Buckley Dec., Ex. L) at 2. The 2001 Proxy Statement includes a notice that F5's 2001 Annual Meeting would occur on April 20, 2001. 2001 Proxy Statement (Buckley Dec., Ex. H) at 1. And F5's closing stock price on April 20, 2001 was ***$8.10***. In other words, the April 20, 2001 grant was the result of a non-discretionary, fully

[25] The Court admonished Plaintiffs for representing, in the original Complaint, that the April 20, 2001 grant was one of the lowest for the month, and for illustrating the grant with a misleading chart. *See* Order at 15 n.8.

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disclosed plan to grant certain non-employee Directors options on the date of the Company's Annual Meeting. That Annual Meeting date was disclosed to the public over a month ***in advance***. Consequently, it is literally impossible that the April 20, 2001 grant, which occurred on a pre-disclosed date-certain, was "backdated."[26]

Even if the April 20, 2001 grant were not the product of a non-discretionary plan, Plaintiffs' attack of that grant is *still* flawed for a variety of reasons. Plaintiffs allege that the April 20, 2001 grant was first disclosed to the SEC on May 8, 2001. AC ¶ 83.[27] Plaintiffs' entire justification for challenging a grant that occurred at the second-***highest*** monthly price is that F5's stock price rose 37.8% in the 20 trading days following the grant. AC ¶ 83. But the grant was disclosed just 12 trading days later, so the 20-trading-day return is an utterly meaningless metric. Moreover, as the Court noted, F5's stock closed lower than the April 20, 2001 strike price on seven of the twelve trading days between the grant and its disclosure. Order at 14. In sum, Plaintiffs' "backdating" theories are, at best, sloppy and, at worst, designed to mislead — Plaintiffs' "analysis" is based on demonstrably inaccurate facts and indisputably inapplicable theories. This is not how fraud is pled.

3. May 6, 2002 Grant

Plaintiffs allege that, on May 6, 2002, options were granted to F5 executives and Directors, including McAdam, Guelich, Grinstein, and Higginson. AC ¶ 86. The exercise price of those options was $11.12, which was the lowest closing price of the month for F5's stock. *Id.* But as with the other two "key" grants, Plaintiffs cannot establish that the May 6, 2002 grant was "backdated."

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[26] This glaring and fatal error in Plaintiffs' reasoning may (and should) explain why Plaintiffs abandoned their challenge to the February 13, 2003 and April 29, 2004 grants. The 2003 Annual Meeting occurred on February 13, 2003. 2003 Proxy Statement (Buckley Dec. Ex. P) at 1. The stock price on February 13, 2003 was $12.79, and Higginson, Guelich, and Grinstein were each granted 15,000 options in February 2003 at that price. 2004 Proxy Statement at 5. The 2004 Annual Meeting occurred on April 29, 2004. 2004 Proxy Statement at 1. The stock price on April 29, 2004 was $28.10, and Higginson, Guelich, and Grinstein were each granted 15,000 options in April 2004 at that price. 2005 Proxy Statement (Buckley Dec., Ex. Q) at 5. Those grants were clearly ***not*** backdated, because they were priced as of a specific, ***pre-disclosed*** date. The fact that Plaintiffs failed to recognize that the April 20, 2001 grant was also a non-discretionary grant priced as of the date of the Company's Annual Meeting reveals that Plaintiffs' "review of each grant" was not as rigorous, thorough, or careful as Plaintiffs would have this Court believe.

[27] In its Order, the Court found that the April 20, 2001 grant was first disclosed to the SEC on May 3, 2001. *See* Order at 14. While Higginson's, Guelich's, and Grinstein's Forms 4 were signed and dated on May 3, 2001, they were not actually filed with the SEC until May 8, 2001.

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In the 2002 Proxy Statement, F5 disclosed as follows: "All non-employee directors who also serve on a board committee and who have been on the board for at least six months will receive options to purchase 15,000 shares ***in May 2002***. In subsequent years these directors will receive options to purchase 15,000 shares on the day of the Company's annual meeting." 2002 Proxy Statement (Buckley Dec., Ex. L) at 2 (emphasis added).[28] F5's 2003 Proxy Statement then disclosed: "In May 2002, each of Messrs. Higginson, Guelich, and Grinstein was granted options to purchase 15,000 shares of Common Stock at an exercise price of $11.12 per share under the 1998 Plan. All options granted under the 1998 Plan were fully vested and exercisable on the date of the grant." Note that the Proxy Statement did ***not*** indicate that the May 2002 grant was priced at fair market value on the date of the grant. Thus, because the 1998 Plan expressly permits the granting of below-market options, the May 6, 2002 grant "was within the allowable percentage for 'in the money' options under the 1998 Equity Incentive Plan." Order at 16:10-11.

Plaintiffs' challenge of the May 6, 2002 grant is based entirely on the fact that the exercise price was at a monthly low. But as the Court already held, "this alone is not sufficient to show with particularity that the option was backdated." Order at 16:16. The Court noted that the odds of the exercise price <u>randomly</u> coinciding with the monthly low was 1 in 22, and that the "relatively modest 7.2% increase" in the stock price following the grant was negligible given the volatility of F5's stock. Order at 16-17. Nothing in the Amended Complaint changes the Court's analysis.

♦

As the Court noted, it is Plaintiffs' "core contention" that the Director Defendants are not "disinterested" (under the first prong of *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)) because they received "backdated" options. Order at 12. As discussed above, Plaintiffs have failed to plead that

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[28] As discussed above, in subsequent years, F5 *did* grant the non-employee Directors options on the dates of the Company's Annual Meeting (February 13, 2003 and April 29, 2004). The 2002 Proxy Statement provides that those specific options — *i.e.*, those options granted as of the date of the Company's Annual Meeting — would have an exercise price equal to the closing price of the Company stock on the date of the grant. 2002 Proxy Statement at 2. The May 6, 2002 grant was <u>not</u> one of those grants — F5's 2002 Annual Meeting was on March 7, 2002. *See* 2002 Proxy Statement (Buckley Dec., Ex. L) at 1.

a majority of the relevant Directors received "backdated" options. As such, Plaintiffs cannot satisfy the first test for demand futility. Order at 19 ("[P]laintiffs have failed to establish reasonable doubt that the Director Defendants are disinterested based on receipt of backdated options ...").

D. The Remaining Six Grants Were Not "Backdated."

In addition to the three "key" grants, Plaintiffs also challenge six additional grants: (1) October 1, 1999; (2) February 10, 2000; (3) July 24, 2000; (4) April 27, 2001; (5) May 8, 2003; and (6) April 30, 2004. AC ¶ 68. No more than one relevant Director received options in any of those additional grants. Consistent with the Court's approach in dismissing the original Complaint, it is not necessary for the Court to specifically analyze each of those six grants. Plaintiffs' "statistical model" of F5's grant patterns — which is, in actuality, not an "analysis" at all, but merely a review of stock price movements — is insufficient, as a matter of law, to establish that any "backdating" occurred at F5. Order at 23-24. That holding alone ends the inquiry.[29] Nevertheless, F5 will briefly address why the remaining option grants were not "backdated."

1. October 1, 1999 Grant

Plaintiffs have no standing to challenge this grant. Under the Washington Corporation statute, an entity may not proceed derivatively on behalf of a corporation unless that entity "was a shareholder of the corporation when the transaction complained of occurred ...." RCW 23B.07.400(1). None of the Plaintiffs were F5 shareholders in October 2000. AC ¶¶ 17-20. Consequently, Plaintiffs may not challenge the October 1, 1999 grant. Moreover, this grant was to a single person — defendant Carlton Amdahl — who is not one of the relevant Directors. AC ¶ 74. Finally, in the weeks preceding October 1, 1999, F5's stock traded below the October 1 closing price of $68.06 (*e.g.*, $65.75 on September 23, 1999). Because this grant was made before the enactment

[29] The first *Aronson* prong also permits a putative derivative plaintiff to demonstrate that a majority of the board "lacks independence." *Aronson*, 473 A.2d at 814. In the original Complaint, Plaintiffs half-heartedly attacked the relevant Directors' independence by alleging that the Directors are "allies" and "personal friends," some of whom are purportedly "dominated and controlled" by other Directors. The Court summarily rejected that approach as patently inadequate under the law. Order at 19. The Amended Complaint adds no facts to bolster Plaintiffs' insufficient allegations or to raise any doubt whatsoever regarding the F5 Directors' independence. Thus, for the purposes of this Motion, the Court need not engage in any "independence" analysis.

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of Sarbanes-Oxley, F5 could (and logically would) have looked back farther for a more advantageous date if the Company was, in fact, engaged in deliberate "backdating."

2. **February 10, 2000 Grant**

Defendant Amdahl (not a relevant Director) was also the only recipient of the February 10, 2000 grant. AC ¶ 76. The grant was issued after a significant decline in F5's stock price (the stock was trading at over $130.00 at the end of January 2000, and had fallen to $89.50 on the grant date). As discussed above, that was a logical time for the Company to grant options. Moreover, the grant occurred during a period of substantial volatility in F5's stock *and* the options were subject to three-year vesting, so any potential value to be obtained by "backdating" was at best highly speculative.

3. **July 24, 2000; May 8, 2003; and April 30, 2004 Grants**

For the alleged option grants on July 24, 2000; May 8, 2003; and April 30, 2004, defendant McAdam was the only Director to receive options. AC ¶¶ 78-79, 88, 92. The July 24, 2000 grants were made following a steep decline in F5's stock price (the stock closed at $55.12 on July 13, 2000 and at $42.56 on the grant date). In addition, the grant came in the middle of a period of substantial volatility in the stock. *See* AC ¶ 79 (stock price chart). It would have been logical and reasonable for the Company to grant options when it did, based on the assumption that the stock was undervalued and that the price could be expected to rebound (as it had in the recent past).[30] The same analysis applies to the April 30, 2004 grant, which followed a prolonged decline in F5's stock price. *See* AC ¶ 91 (stock price chart). The Company's rational and wholly appropriate incentive to grant options when the stock price was low (predicting a recovery), coupled with the fact that the odds of randomly hitting a monthly low point in a particular month was approximately 1 in 22, undercuts any inference of "backdating."

Conversely, the May 8, 2003 grant (with an exercise price of $14.64) occurred right in the middle of a sustained rise in F5's stock price. *See* AC ¶ 89 (stock price chart). If F5 were

[30] In addition, it should be noted that McAdam subsequently agreed to voluntarily cancel the 645,000 options he was granted on July 24, 2000. 2003 Proxy Statement (Buckley Dec., Ex. P) at 9. That is not the conduct of an individual engaged in a fraudulent "backdating" conspiracy.

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"backdating," it could have gone back just a few additional trading days and obtained a much more favorable exercise price (*e.g.*, the stock closed at $13.66 on May 1, 2003). As this Court has already ruled, Plaintiffs' reliance on bare odds and stock price movements is simply inadequate to establish that any of these grants were deliberately "backdated." Order at 21-23; *see also CNET*, 483 F. Supp. 2d at 960 ("***Mere reliance on the numbers is not sufficient when plaintiffs are confronted with a legitimate, judicially-noticeable explanation for the grant date***. To plead with particularity that this grant was backdated, plaintiffs would need to allege specific facts showing that this was not the true grant date") (emphasis added).

4. April 27, 2001 Grant

Plaintiffs challenge the April 27, 2001 grant, despite the fact that the exercise price of $7.00 was only the ***thirteenth***-lowest closing stock price of the month. AC ¶ 84. Plaintiffs' claim that this grant was "backdated" is based entirely on the fact that F5's stock price increased 56%, to $11.10, on the date the grant was disclosed to the SEC. AC ¶ 85. But the April 27, 2001 grant occurred in the middle of a sustained rise in F5's stock price (with the stock trading at below $4.00 near the beginning of April 2001 and over $18.00 near the end of June 2001). ***Any*** option grant that was made during such a rise would be characterized by post-grant returns. One could undoubtedly identify many dates in F5's history that would have yielded significant returns had options been granted on those dates. If the fact of positive returns alone indicates "backdating," then ***every*** favorable (or "lucky") grant would be evidence of fraud. Yet Plaintiffs are just as insistent that the April 27, 2001 grant was "backdated" as they are that the other F5 grants were "backdated." Under even minimal scrutiny, Plaintiffs' theories collapse.

♦

In summary, Plaintiffs have failed to plead, with particularity or otherwise, that ***any*** F5 grant was the product of deliberate and fraudulent "backdating." That failure alone defeats the Amended Complaint, just as it defeated the original Complaint. Because Plaintiffs cannot establish that a majority of the relevant Directors are "interested," Plaintiffs must instead establish that the

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option grants were not the product of a valid exercise of business judgment (the second *Aronson* prong). Order at 20. But if the grants were not "backdated," they are obviously protected by the business judgment rule. Order at 24. That ends the demand-futility inquiry.

E. <u>The General "Business Judgment" Allegations Are Inadequate As A Matter Of Law.</u>

Plaintiffs try to create the appearance that they have bolstered their demand-futility arguments by adding generalized allegations regarding the Director Defendants' exercise of business judgment. The Amended Complaint adds a paragraph alleging that Defendants Higginson, Guelich, Grinstein, and Malone "granted backdated options" on various dates. AC ¶ 176(b). But that allegation is based on nothing more than the fact that Higginson, Guelich, Grinstein, and Malone were serving on F5's Compensation Committee at the time of the grants. The Court already rejected precisely this argument. Order at 20:25-21:6 ("[P]laintiffs provide no particularized allegations showing that Director Defendants Higginson, Guelich, Grinstein, and Malone chose the date on which the allegedly backdated options were to be granted or that they knew a grant's true date. Plaintiffs' allegations that because Director Defendants Higginson, Guelich, Grinstein, and Malone were on the Compensation Committee and Audit Committee, they must have known, 'do not constitute particularized facts'") (citing *CNET*). Plaintiffs have alleged no new ***facts*** to provide the particularity that the Court found lacking — instead, Plaintiffs merely itemize the grants that occurred during each Director Defendant's tenure on the Compensation Committee. AC ¶ 176(b).

Similarly, Plaintiffs have re-worded some of their allegations regarding the F5 Board's oversight of the Company's financial and accounting practices. Plaintiffs allege that "pre-suit demand on the F5 Board of Directors is also futile and, therefore, excused because all of its members signed one or more of F5's annual reports on Forms 10-K between 1999 and 2006 that contained false and misleading financial results and information. ... In each of these Forms 10-K, defendants represented that the financial information contained therein was accurate. Instead, however, while under the stewardship of defendants McAdam, Higginson, Guelich, Grinstein, Malone and Ames, the secret backdating scheme particularized in this Complaint was being perpetrated upon and

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causing great injury to F5." AC ¶ 176(e)-(f). Again, the Court has already considered and rejected Plaintiffs' arguments. Even if the above allegations were accurate, at most they would create a threat of liability for the Board, but the law is quite clear that such a threat is not sufficient to establish demand futility. Order at 21 ("[A] plaintiff may not bootstrap allegations of futility by pleading merely that the directors participated in the challenged transaction or that they would be reluctant to sue themselves") (internal quotation omitted). More to the point, the allegation that F5's financial statements were false or misleading is premised entirely on the Company's option grants having been "backdated," which Plaintiffs have clearly failed to establish. Order at 21-22.

Plaintiffs also add a generalized allegation to the effect that "defendants Higginson, Guelich and Grinstein also stood on both sides of several stock option grants because they each received backdated stock option grants ...." AC ¶ 176(c). As discussed at length above, Plaintiffs have not pled particularized facts suggesting that any relevant Director received "backdated" options. And Plaintiffs add an allegation that "[b]etween 1999 and 2006, defendants caused F5 to send shareholders proxy statements in connection with the Company's annual shareholder meetings. Each proxy statement was submitted to shareholders by the entire Board of Directors." AC ¶ 97. But, as discussed above, Plaintiffs have failed to establish that any of the F5 Proxy Statements contained misrepresentations regarding F5's options practices.

Plaintiffs' free-floating allegations of alleged misconduct in Paragraph 176 of the Amended Complaint are virtually identical to the generalized demand-futility allegations that Judge Zilly found inadequate, as a matter of law, in *Cray*. 431 F. Supp. 2d at 1121. And this Court also rejected those same allegations in Plaintiffs' original Complaint. Order at 20-22.[31] The Amended Complaint adds nothing of substance to Plaintiffs' general demand-futility allegations — it merely restates a

[31] Plaintiffs continue to argue that F5 "admitted" that a "backdating scheme" was perpetrated at the Company because F5 announced, in October 2006, that it would restate its financials as a result of the internal investigation the Company conducted. AC ¶ 176(f). In its Reply brief in support of the motion to dismiss Plaintiffs' original Complaint, F5 explained in great detail why F5's restatement was clearly ***not*** an admission that any "backdating" occurred, and was, in fact, entirely consistent with innocent errors in either selecting grant dates or accounting for options. Reply at 12-18. The Court gave no credence whatsoever in the Order to Plaintiffs' contention that F5 "admitted" engaging in fraud. As such, F5 will not repeat here its detailed rebuttal of that contention.

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few of those allegations in slightly more detailed language. Consequently, there is no basis for the Court to reverse its prior ruling.

F. <u>Plaintiffs Should Be Denied Further Leave To Amend Their Allegations</u>.

A plaintiff should not be given leave to amend a complaint if the amendment would be "an exercise in futility" (*i.e.*, if the flaws in the underlying claims are too fundamental to be corrected). *Steckman v. Hart Brewing, Inc.*, 143 F.3d 1293, 1298 (9th Cir. 1998); *Lipton v. PathoGenesis Corp.*, 284 F.3d 1027, 1039 (9th Cir. 2002) (affirming District Court's Rule 12(b)(6) dismissal with prejudice of initial complaint because amendment would be futile where the "basic facts" had been alleged and were inadequate to state a claim). Denial of leave to amend is also appropriate where a plaintiff has had ample time, and multiple opportunities, to plead viable claims. As the *CNET* Court found in denying further leave to amend:

> This is the fourth iteration of plaintiffs' complaint. Plaintiffs were granted two extensions so that they could file their complaint after CNET had released its restated financials. ... Plaintiffs had every incentive to plead their best case in this complaint. This action has been going on for nearly nine months, so plaintiffs had ample opportunity to investigate their allegations. The Court is inclined to deny further leave to amend in light of the prior history of this action.

483 F. Supp. 2d at 966-67.

The facts of this case are strikingly similar to the facts in *CNET* that justified dismissal without further leave to amend. The Amended Complaint is Plaintiffs' <u>third</u> attempt to plead sustainable claims. The first of Plaintiffs' three subsequently consolidated complaints was filed on June 8, 2006. AC ¶ 174; Order at 4:3. On November 30, 2006, Plaintiffs filed their Consolidated Verified Shareholders Derivative Complaint. It was that Complaint the Court analyzed and dismissed in the Order. Thus, the Amended Complaint represents Plaintiffs' third opportunity to plead viable demand-futility allegations.

This action has been pending for ***seventeen*** months, so Plaintiffs have had ample time to thoroughly investigate their claims. And Plaintiffs filed the Amended Complaint after the Court provided a precise roadmap (*i.e.*, the Order) to the fatal flaws in Plaintiffs' allegations. Plaintiffs

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had not just time, but every incentive, to allege all facts they are aware of that would suggest improper "backdating" occurred at F5. As discussed above, Plaintiffs have failed to raise even a plausible inference that anyone at F5 engaged in fraud. It is clear that Plaintiffs do not posses additional facts supporting their demand-futility allegations, or they would have pled those facts. As such, any additional amendment would be futile, and the Amended Complaint should be dismissed without leave to amend.

III. CONCLUSION

"[W]hen the allegations in a complaint, however true, could not raise a claim of entitlement to relief, this basic deficiency should be exposed at the point of minimum expenditure of time and money by the parties and the court." *Twombly*, 127 S. Ct. at 1966. In this case, that time is now. The Court instructed Plaintiffs on the specific deficiencies in their demand-futility allegations, and gave Plaintiffs an opportunity (a third opportunity) to cure those deficiencies. In response, Plaintiffs alleged no new substantive facts that in any way bolster Plaintiffs' accusation that F5 engaged in fraudulent "backdating." It is not equitable for the Court or F5 to be forced to expend additional time or money responding to claims that clearly cannot be salvaged. F5 respectfully requests that the Amended Complaint be dismissed with prejudice. A form of order is submitted with this Motion.

RESPECTFULLY SUBMITTED this 16th day of November, 2007.

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CERTIFICATE OF SERVICE

I hereby certify that on this 16th day of November, 2007, I caused the foregoing to be electronically filed with the Clerk of the Court using the CM/ECF System which will send notification of such filing to the following:

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Dated at Seattle, Washington, this 16th day of November, 2007.

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THE HONORABLE ROBERT S. LASNIK

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

In re F5 NETWORKS, INC. DERIVATIVE LITIGATION.	**Master File No. C06-0794 RSL** **REPLY IN SUPPORT OF NOMINAL DEFENDANT F5 NETWORKS, INC.'S MOTION TO DISMISS AMENDED COMPLAINT FOR FAILURE TO MAKE DEMAND** **NOTE FOR MOTION CALENDAR: TUESDAY, FEBRUARY 19, 2008** **[ORAL ARGUMENT REQUESTED]**

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By filing this lawsuit, Plaintiffs have asked this Court to do something that all courts nationwide are deeply, and properly, reticent to do: usurp the fundamental role of a corporation and its board to "rectify an alleged wrong without litigation, and to control any litigation which does arise." *Aronson v. Lewis*, 473 A.2d 805, 809 (Del. 1984). Plaintiffs want this Court to substitute Plaintiffs' judgment for that of F5 and its Board of Directors. To circumvent bedrock principles of corporate governance, Plaintiffs must meet a strict standard, "more onerous than that required to withstand a Rule 12(b)(6) motion to dismiss." *Levine v. Smith*, 591 A.2d 194, 207 (Del. 1991). Indeed, Plaintiffs' burden is even more onerous than the standards under Rule 9(b) for pleading fraud, because Plaintiffs must not only plead ***particularized*** facts, but "ultimate facts" or "elemental facts," *i.e.*, those specific facts that will actually sustain a claim. *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000); *accord In re Cray Inc. Deriv. Litig.*, 431 F. Supp. 2d 1114, 1121 (W.D. Wash. 2006). The shrill conviction of Plaintiffs' "backdating" accusations must not drown out the fact that Plaintiffs ask this Court to grant relief that is extraordinary and highly disfavored.[1]

In opposing F5's Motion, however, Plaintiffs bear an even greater burden than the typical would-be derivative plaintiff. That is so because this Court has already ruled that Plaintiffs' demand-futility allegations ***fail*** as a matter of law. *See* Order Granting Nominal Defendant F5 Networks, Inc.'s Motion To Dismiss For Failure To Make Demand (the "Order"). Despite how loudly Plaintiffs decry F5's Directors as alleged self-interested fraudsters, the Amended Complaint (or "AC") is remarkably silent on the single determinative question currently before the Court: did Plaintiffs add ***new facts*** to the Amended Complaint sufficient to save Plaintiffs' demand-futility allegations from dismissal. In conjunction with its Motion, F5 provided a chart of the "substantive" (*i.e.*, not stylistic or organizational) changes in the Amended Complaint — the Motion then set forth in detail why none of those changes impacts, let alone merits reversal, of the Court's rulings in the Order. Entirely absent from Plaintiffs' Opposition To Nominal Defendant F5 Networks, Inc.'s

[1] *See, e.g., In re Verisign, Inc. Deriv. Litig.*, — F. Supp. 2d —, No. C 06-4165 PJH, 2007 WL 2705221, *11 (N.D. Cal. Sept. 14, 2007) ("[T]he issue raised in this motion is not the propriety or legality of backdating options, but whether plaintiffs, by pleading particularized facts, have overcome the presumption of good faith afforded to directors"; dismissing putative "options backdating" derivative suit because plaintiffs failed to establish that demand was futile).

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Motion To Dismiss Amended Complaint For Failure To Make Demand (the "Opposition") is *any* discussion of new *facts*; instead, Plaintiffs find slightly different (and increasingly confusing) ways to argue their flawed statistical theories. Plaintiffs also attempt to convince the Court that it erred in its articulation and application of the law governing demand futility. The Court did not err, and there are no grounds for reversing the law of the case, as clearly established by the Court in its Order.

As discussed below, the Amended Complaint fails in the same fundamental way that Plaintiffs' original Complaint failed: the Amended Complaint raises *no* inference, reasonable or otherwise, that any of F5's option grants were "backdated." Stated differently, Plaintiffs are still unable to plead ultimate facts, with particularity, demonstrating that anyone at F5 engaged in fraud.[2]

I. ANALYSIS

A. Plaintiffs Ask The Court To Reverse Itself On The Applicable Legal Standards.

1. The Court Rejected The *Maxim* Approach.

In the Order, the Court established the core standard governing Plaintiffs' demand-futility allegations: Plaintiffs must "present particularized facts creating a reasonable doubt that the directors are disinterested." Order at 12:5-6. That burden has been further informed by the U.S. Supreme Court's decision in *Bell Atlantic Corporation v. Twombly*, 127 S. Ct. 1955 (2007), which requires Plaintiffs to plead their claims "across the line from ***conceivable*** to ***plausible***." *Id.* at 1974 (emphasis added). As discussed in the Motion, and further below, Plaintiffs' allegations in the Amended Complaint do not satisfy either of those pleading standards.

For obvious reasons, Plaintiffs cling desperately and doggedly to *Maxim* (*Ryan v. Gifford*, 918 A.2d 341 (Del. Ch. 2007)) and the handful of cases that have followed the *Maxim* approach. Opposition at 8-9. But, contrary to Plaintiffs' assertion, this Court *did* reject the *Maxim* methodology, because *Maxim* sets an unreasonably low bar for would-be derivative plaintiffs to

[2] *See In re InfoSonics Corp. Deriv. Litig.*, No. 06-CV-1336 BTM, 2007 WL 2572276 (S.D. Cal. Sept. 4, 2007) ("[Directors] enjoy the benefit and protection of the business judgment rule, and their control of corporate affairs should not be impinged based on non-specific or speculative allegations of wrongdoing"; dismissing putative "options backdating" derivative action where plaintiffs failed to adequately plead that demand was futile).

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plead demand futility. In the Order, the Court cited cases that, in turn, cite *Maxim*, but only for the uncontroversial (and self-evident) proposition that "intentionally employing hindsight to adjust the grant date to an advantageously low price, or 'backdating,' is fraud." *See, e.g.*, Order at 11:22-12:2 (quoting *In re CNET Networks, Inc. S'holder Deriv. Litig.*, 483 F. Supp. 2d 947, 956 (N.D. Cal. 2007)). But the Court implicitly rejected *Maxim*'s central holding that a derivative plaintiff may establish demand futility merely by alleging that (i) the company's stock plans require options to be granted at 100% of fair market value on the grant date, and (ii) the directors employed hindsight to choose favorable grant dates.[3] Instead, the Court engaged in a grant-specific analysis to determine whether Plaintiffs pled particularized facts to establish that each grant in question was actually "backdated." *See* Order at 13-19. Moreover, the Court refused to accept Plaintiffs' conclusory (and false) assertion that F5's stock option plans required <u>every</u> stock option to be granted at 100% of fair market value on the date of the grant. *See* Order at 16.[4]

2. <u>The *Getty* Decision Is Distinguishable.</u>

Plaintiffs rely on Judge Robart's recent decision in *Edmonds v. Getty*, 524 F. Supp. 2d 1267 (W.D. Wash. 2007), but *Getty* involved a significantly different set of facts and circumstances than those at issue here. <u>First</u>, and perhaps most importantly, Getty Images appointed a special committee and conducted an internal investigation, after which the Company publicly disclosed that "[t]he Special Committee also identified certain awards ***for which grant dates were selected retroactively***." 524 F. Supp. 2d at 1270 (emphasis added). Consequently, the backdrop to Judge Robart's entire analysis was the fact that apparently Getty had effectively admitted "backdating"

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[3] The *Maxim* Court also reviewed purported "empirical evidence" in the form of graphs and statistical metrics, but as F5 has demonstrated in both of its dismissal motions (and this Court has agreed, as discussed further below), such "statistical models" are not, in fact, evidence of anything. Moreover, it is important to recall that, according to Chancellor Chandler, the *Maxim* case involved "unusual facts," including that <u>all</u> of the challenged grants occurred at low points in the stock price and that plaintiffs performed a complete market analysis of returns. 918 A.2d at 354.

[4] Perhaps the most obvious indication that the Court rejected the *Maxim* standard is that the Court never cited *Maxim*. The courts that have followed *Maxim*'s lead — beyond merely observing the truism that deliberately violating stock option plans and lying to shareholders is fraud — have quoted directly and extensively from Chancellor Chandler's findings. This Court correctly took a different approach, and neither cited nor relied on *Maxim*.

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(a fact that is absolutely ***not*** present here).[5] Second, the plaintiff in *Getty* claimed that "21 out of 25 discretionary grant dates from April 1999 to 2002 were backdated." *Id.* at 1272. Here, Plaintiffs challenge less than half as many grants (nine) made over a period more than twice as long (1999 to 2006). Third, in *Getty*, of the challenged grants, "[e]ight grants were made at or near the lowest price for the fiscal ***year*** and fourteen were made at or near the lowest price of the fiscal ***quarter***." *Id.* at 1272 (emphasis added). Here, by contrast, Plaintiffs allege that "12 of 26 stock option grants to F5's directors and top officers fell on the 2 most favorable dates, *i.e.*, the lowest (9) or second lowest (3) ***monthly*** closing price of F5's common stock." AC ¶ 2 (emphasis added). Thus, the bare odds that the *Getty* plaintiffs relied upon were substantially more "dramatic" than the odds of F5's grant pattern occurring randomly.[6] Fourth, under Getty's stock option plans, ***all*** options had to be priced at "no less than 100% of the Fair Market Value per share on the date of the grant." *Id.* at 1273. Here, it is undisputed that F5's 1998 Stock Plan "allow[s] a grant to be discounted to as much as 50% of the fair market value of F5 stock on the date of the grant." AC ¶ 48.[7]

The *Getty* decision distinguishes several other "backdating" opinions on the grounds that "none of the[] deficiencies [in those cases] are present here." 524 F. Supp. 2d at 1275. But here, the Amended Complaint ***does*** suffer from most of the deficiencies identified in those opinions, which highlights that the *Getty* case and this case are distinguishable on their facts. For example, *Getty*

[5] Despite Plaintiffs' continued assertion that F5 "admitted" that it engaged in "backdating," F5 admitted nothing of the sort. Following its internal investigation, F5 publicly disclosed that certain measurement dates should not be relied upon due to (i) administrative delays in allocating company-wide grants to employees, (ii) options granted to new employees before their official start dates, (iii) insufficient documentation to support certain grant dates, (iv) failure to properly account for consultants who later became employees, and (v) failure to properly account for options that were modified after the grant date. F5 2006 Form 10-K/A at 17. None of those disclosures involved an "admission" that F5 "retroactively selected" grant dates (as occurred in *Getty*). ***See also CNET***, 483 F. Supp. 2d at 963 ("Plaintiffs have not pleaded with particularity that the contents of the restated financials [including the special committee's conclusion that no wrongdoing occurred] are untrue. Accordingly, plaintiffs may not rely on them as an automatic admission of fraud").

[6] The *Getty* decision does not evaluate or analyze the plaintiff's odds-based allegations; instead, *Getty* accepts the reasoning in *Maxim* that the simple fact of an improbable grant pattern supports an inference of "backdating" (*i.e.*, fraud). 524 F. Supp. 2d at 1276. With the utmost respect for Judge Robart, the *Getty* decision is in error on this point. As F5 has analyzed in detail, and as this Court recognized in its Order, the "statistical model" Plaintiffs rely upon does not raise ***any*** inference of fraudulent conduct.

[7] In issuing the *Getty* decision, Judge Robart had the benefit of this Court's Order. (Getty Images submitted a copy of the Order with its dismissal briefing.) The fact that he did not cite or discuss the Order suggests that Judge Robart also recognized the *Getty* case and this case as factually distinguishable.

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distinguishes *CNET* on the grounds that, in *CNET*, "the court refused to find demand excused where plaintiffs failed to plead facts about the full universe of options ... or any facts regarding the board's role in granting the options." *Getty*, 524 F. Supp. 2d at 1275. Both of those deficiencies are present in this case: Plaintiffs have analyzed only grants made to "directors and top officers," as opposed to rank-and-file employees (AC ¶ 2), so Plaintiffs' analytical approach is flawed because it omits the context of the "full universe of options." *See CNET*, 483 F. Supp. 2d at 957. Moreover, Plaintiffs here "provide no particularized allegations showing that [the F5 Director Defendants] ***chose the date on which the allegedly backdated options were to be granted or that they knew a grant's true date.***" Order at 20:25-26:3 (citing *CNET*) (emphasis added).

The *Getty* decision distinguishes two other "backdating" opinions on the same basis it distinguishes *CNET*. *Getty* distinguishes *Verisign* on the grounds that, in that case, there were "no allegations showing how or why a particular director would know that the options were backdated." *Getty*, 524 F. Supp. 2d at 1275. *Getty* also distinguishes *Desimone v. Barrows*, 924 A.2d 908 (Del. Ch. 2007), on the grounds that the complaint in that case "was devoid of any factual allegations on the key issues of who approved the employee grants and whether any of the directors knew that options were being backdated." 524 F. Supp. 2d at 1275. (*Desimone* is further distinguishable from *Getty* because, as in our case, the stock option plans in *Desimone* did not require options to be priced fair at market value. *Id.*) Here, as in *Verisign* and *Desimone*, the Court already held that Plaintiffs have failed to adequately plead that F5's Directors chose the particular measurement dates for the challenged grants or knew the "true" dates of those grants. Order at 21; *see also In re Finisar Corp. Deriv. Litig.*, No. C-06-07660 RMW, 2008 WL 131867, *13 (N.D. Cal. Jan. 11 2008) (dismissing putative derivative action, despite company's admission of backdating, where complaint was "devoid of any factual allegations of which directors approved which backdated employee grant and whether the directors knew the options were backdated").

The *Getty* decision also distinguishes *In re Linear Technology Corporation Derivative Litigation*, No. C-06-3290 MMC, 2006 WL 3533024 (N.D. Cal. Dec. 7, 2006). *Getty*, 524 F. Supp.

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2d at 1275. This Court specifically relied on *Linear* in rejecting the notion that Plaintiffs' "statistical model" (such as it is) establishes any inference of backdating. *See* Order at 22. In fact, the language that *Getty* uses to distinguish *Linear* is the same language this Court quoted as "instructive." *Id.* Similarly, *Getty* distinguishes *In re PMC-Sierra, Inc. Derivative Litigation*, No. C 06-05330 RS, 2007 WL 2427980 (N.D. Cal. Aug. 22, 2007), because, in that case, "demand was not excused where plaintiff did not present an adequate statistical analysis to negate the prospect that the favorable grant dates were merely fortuitous, did not examine all options granted during the relevant period and failed to allege other facts raising an inference that backdating occurred." *Getty*, 524 F. Supp. 2d at 1275. In our case, by contrast, the Amended Complaint suffers from all the key deficiencies identified in *PMC-Sierra* (as discussed further below).[8]

In summary, *Getty* is inapposite because it involved a substantially different set of underlying facts. The Amended Complaint suffers from all of the factual and pleading deficiencies that Judge Robart used to distinguish the cases discussed above.[9] Contrary to Plaintiffs' assertion, nothing in *Getty* suggests, let alone compels, that the Court reverse its prior rulings.

Plaintiffs make the surprising assertion that they "easily satisfy both prongs of the *Aronson* test." Opposition at 7:16. This Court obviously disagreed and, in the Order, dismissed Plaintiffs' claims for failure to plead demand futility. The only way Plaintiffs' allegations even conceivably survive is if the Court applies the extremely low pleading threshold established in *Maxim*, but the Court has already rejected that methodology. Ironically, Plaintiffs accuse F5 of arguing that

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[8] The *Getty* decision also distinguishes *In re Openwave Systems Inc. Shareholder Derivative Litigation*, 503 F. Supp. 2d 1341 (N.D. Cal. 2007), because, in that case, the plaintiff failed to "compare the average 20 day return on all reported stock option grants during the relevant period to the average 20 day return on Openwave stock during the period." 524 F. Supp. 2d at 1275 (quoting *Openwave*). Here, Plaintiffs also failed to perform that broader analysis — instead, they focused solely on F5's percentage returns, without providing any context regarding percentage returns experienced market-wide. As discussed below, the Merrill Lynch study (on which Plaintiffs' rely) found that *all* companies Merrill Lynch analyzed (not just those it identified as being "at risk" of "backdating") experienced higher 20-day returns than annualized returns. That is a fact conspicuously omitted from Plaintiffs' Amended Complaint and briefing.

[9] It should also be noted that Judge Robart rejected certain analytical metrics this Court found compelling. The *Getty* decision gave no weight to the fact that "there were days close in time [to the grant date] where the stock closed at an even lower price ...." 524 F. Supp. 2d at 1273. This Court, however, found that fact alone sufficient to defeat an inference of "backdating." *See* Order at 15:1-6.

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"this Court has created a new test for demand futility." Opposition at 9:9-10. To the contrary, this Court closely followed the standards set out in *Aronson* (and reaffirmed in cases such as *Cray*), which require putative derivative plaintiffs to meet an extremely exacting burden to adequately plead fraud and usurp the fundamental role of a company's board of directors.[10] In fact, it is cases such as *Maxim* that pervert and undermine the *Aronson* standards, by making it dangerously easy for plaintiffs (and, more to the point, their counsel) to establish demand futility.[11]

B. Plaintiffs' Generalized "Statistical" Theories Are Inadequate To Establish Fraud.

In their original Complaint, Plaintiffs identified various F5 option grants that occurred at or near monthly lows, declared the odds of such a pattern occurring randomly "wildly improbable," and asked the Court to conclude, based on that "analysis," that F5 engaged in rampant fraud. The Court correctly declined to reach that conclusion, observing that Plaintiffs' allegations were not "based on any type of statistical model." Order at 23:1. Now Plaintiffs claim that the Court did not reject their statistical approach, but "merely held that plaintiffs did not meet their pleading burden regarding the use of a statistical model as part of the overall allegations establishing a pattern of stock option backdating." Opposition at 10:11-13. However Plaintiffs wish to euphemistically phrase the point, the Court found Plaintiffs' statistics-based, non-grant-specific methodology wholly inadequate to

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[10] Plaintiffs apparently misapprehend the meaning and operation of the "law of the case" doctrine. Plaintiffs contend that the doctrine "only prevents a party from asking the court to reconsider an issue that has already been decided by the same or a higher court in the identical case." Opposition at 10:19-20. That is precisely what Plaintiffs are attempting to do. In their opposition to F5's first dismissal motion, Plaintiffs argued that the *Maxim* standards applied and excused demand. In their opposition to the current motion, Plaintiffs continue to insist that the *Maxim* standards apply and excuse demand. (In fact, immediately after noting that the Court "did not even mention" *Maxim* in the Order, Plaintiffs make the perplexing claim that the Court "explicity adopted the demand futility test used by the *Ryan* [*Maxim*] court." Opposition at 10.) In short, Plaintiffs ask this Court to reconsider the proper standards for measuring demand futility, but that is what the "law of the case" doctrine prohibits. *See United States v. Alexander*, 106 F.3d 874, 877 (9th Cir. 1997). Plaintiffs' attempt to distinguish *Alexander* is equally baffling. *See* Opposition at 11 n.9. In *Alexander*, the "law of the case" doctrine applied despite the earlier ruling having been made by a different judge; the doctrine applies with even more force here, where Plaintiffs ask the same judge to reverse himself on the law.

[11] Indeed, Chancellor Chandler (the presiding judge in *Maxim*) appears to be attempting to re-write the law of demand futility. In November 2007, in the same case, Chancellor Chandler ruled that communications between counsel for Maxim's Special Committee and Maxim's Board were not afforded any attorney-client privilege protection. *See Ryan v. Gifford*, No. 2213-CC, 2007 WL 4259557 (Del Ch. Nov. 30 2007). That is a startling ruling that will surely reduce companies' incentive and ability to proactively investigate and address potential internal issues. Until the Delaware Supreme Court has reviewed the *Maxim* decisions, it is at best premature to assume that Chancellor Chandler's rulings mark a radical shift in the Delaware law governing demand futility.

plead demand futility. Instead, the Court performed a ***grant-specific*** analysis, eschewing general odds and "patterns" in favor of evaluating the inferences (if any) to be drawn from the facts surrounding each challenged grant. *See* Order at 12-19.

This Court is not alone in rejecting the type of "statistical analysis" that Plaintiffs' claims depend upon. In *PMC-Sierra*, the same counsel who are representing Plaintiffs here accused PMC-Sierra of fraudulent "backdating," based on allegations that "each of the [challenged] grants was dated 'near or on the very day that PMC-Sierra stock hit its low price for the month' or 'in advance of sharp stock price increases.' As to most of the grants, plaintiffs allege[d] that the stock price 20 days later would have resulted in extraordinarily good returns, often in the range of 20% or 30%." 2007 WL 2427980 at *2. As is the case here, the plaintiffs in *PMC-Sierra* did "not purport to know when any of the options were *actually* granted. Their theory, in essence, [was] that the stated dates of the grants [were] too favorable to have been the product of chance, and therefore must have been selected with the benefit of hindsight." *Id.* Just as this Court rejected Plaintiffs' methodology, the *PMC-Sierra* Court found that the plaintiffs (and their counsel, who make identical arguments to this Court) had "not presented an adequate statistical analysis to negate the prospect that the favorable grant dates were merely fortuitous." *Id.* at *4. The *PMC-Sierra* Court also noted that courts in its judicial district "uniformly have rejected the methodology by which plaintiffs are attempting to support that inference [of fraud]." *Id.* (citing *Linear*, *CNET*, and *Openwave*).

Plaintiffs' generalized statistical approach has been repeatedly rejected by the courts, including this Court in the Order. Critically, the Amended Complaint changes ***nothing*** in Plaintiffs' methodology — the Amended Complaint merely reduces the number of challenged grants (from 12 to 9) and corrects various misleading representations Plaintiffs previously made, and for which they were admonished by the Court (*see* Order at 15 n.8; 18 n.10). Plaintiffs plead ***not one new fact*** that could convert their allegations to a legitimate "statistical model" (even if statistics alone were enough to establish fraud, which they are not). And, as discussed below, the analysis that Plaintiffs *do* employ remains hopelessly flawed.

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1. **<u>The Amended Complaint Omits Option Grants During The Relevant Period.</u>**

In its Order, the Court criticized Plaintiffs for failing to consistently identify how many option grants F5 made during the relevant period (or even how many grants Plaintiffs were challenging as "backdated"). Order at 23-24. Despite that warning, in the Amended Complaint Plaintiffs *still* fail to identify all of the grants made to F5 directors and officers during the putative class period (1999 to 2006). And Plaintiffs' omission is not *de minimis*: they miss nearly ***20%*** of the relevant grants (6 of 32). Perhaps not coincidentally, none of those grants fell at, or even near, a monthly low in F5's stock price. Plaintiffs protest that "no matter how extensive a search of defendants' SEC filings is conducted, some grants are likely to go undiscovered." Opposition at 4 n.3. But the missing grants were all publicly disclosed on Forms 3 and 4, the same forms Plaintiffs purportedly reviewed as part of their "substantial research."[12] (And the Court will recall that Plaintiffs' counsel, at oral argument on F5's first dismissal motion, referred to ***32*** public grants, Order at 23 n.14, suggesting that Plaintiffs were aware of the proper universe of grants but chose to "analyze" only a subset of those grants.) Whether Plaintiffs' omission of 20% of the relevant F5 grants was merely the result of carelessness, or something more deliberate, is ultimately immaterial: the point is that any would-be derivative plaintiff should conduct a thorough (and ***unbiased, outcome-neutral***) investigation before accusing a company and its management of ***fraud***.

2. **<u>Plaintiffs' Generalized "Odds" Allegations Add Nothing To The Analysis.</u>**

In their original Complaint, Plaintiffs claimed that the odds of F5's grant dispersion occurring as the result of random chance were "less than 1 in 90 million." Comp. ¶ 2. Even at those alleged odds, the Court rejected Plaintiffs' "strident claim" that F5's grants reflect an "astonishing multi-year pattern" indicating that "grants were repeatedly backdated." Order at 22. In the Amended Complaint, Plaintiffs substantially reduced their odds, alleging that "[t]he odds that

[12] *See* F5's Motion at 7 n.6. Plaintiffs also complain that, because certain defendants were not officers at the time of the grants, "their SEC forms disclosing those grants were filed years after the fact." Opposition at 4 n.3. But that point is irrelevant. Even the latest-disclosed grants were identified on Forms 3 and 4 filed in 2005, long before Plaintiffs conducted their supposedly "extensive search" of the public information regarding F5's options granting practices.

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9 grants fall on the date with the lowest closing price alone (out of 20 possible trading days) is 1 in 391,905." AC ¶ 72. Now, having realized they omitted nearly 20% of the relevant grants, Plaintiffs have been forced to reduce their odds yet again. Plaintiffs allege that "[t]he odds that 9 out of 32 grants fell on the lowest closing price of the month are ***1 in 52,328***. The odds that 12 out of 32 grants fell on the lowest or second lowest price of the month are ***1 in 30,303***." Opposition at 15 n.12 (emphasis added).[13] Plaintiffs provide no explanation whatsoever for how they calculated those alleged odds, but even accepting Plaintiffs' figures, probabilities of 1 in 30,303 or 1 in 52,328 are not particularly improbable (and certainly not "wildly" so). If Plaintiffs' original odds of 1 in 90 million did not create an inference of fraud, Plaintiffs' drastically reduced odds do not.[14]

3. <u>Plaintiffs' Percentage Return Allegations Are Still Meaningless.</u>

Plaintiffs ignore the fact that the Court found the 20-day-percentage-return metric "meaningless" for most of the challenged grants. Order at 23 n.12.[15] Plaintiffs continue to place substantial reliance on the percentage-return metric in the Amended Complaint and the Opposition, but the analysis has become more confusing. As an initial matter, analyzing 20-day percentage returns on option grants (at least in the manner Plaintiffs do) compares apples to oranges. The 20-day percentage return takes a truncated "snapshot" of the stock's performance; "annualizing" that snapshot (as Plaintiffs purport to have done) artificially and unrealistically assumes that the stock will perform in exactly the same fashion over an entire year. Plaintiffs then compare that

[13] Plaintiffs also argue that "at the rate of granting 32 options every six years, it would still take defendants 9,810 years before defendants' pattern of hitting the monthly low prices would become statistically insignificant." Opposition at 4 n.5. That argument utterly misses the point. The question is not how long it would take for F5's particular grant dispersion to become "statistically insignificant" (a term, incidentally, that Plaintiffs do not bother to define and that has variable meanings). The question is whether ***some*** company, in the distribution of companies granting stock options, would experience the grant dispersion F5 experienced purely as a result of random chance. As discussed in F5's Motion, not only is it not improbable (or "hugely suspicious") that ***some*** company would experience F5's grant dispersion, it is a virtual ***certainty***. *See* Motion at 8. That fact alone defeats any inference of fraud that can possibly be drawn from Plaintiffs' odds-based allegations. Plaintiffs fail to respond in any way to F5's arguments on this point.

[14] As the Court observed at oral argument, statistics alone are simply not probative (in part because they can be easily manipulated or skewed). Moreover, because the Court rejected Plaintiffs' generalized statistical allegations and instead applied a ***grant-specific*** "backdating" analysis, only grant-specific odds are even arguably relevant. And, as the Court has noted, the odds of a particular grant coinciding with the lowest monthly stock price are approximately 1 in 22, which is not even remotely "improbable." Order at 16:17; *see also Openwave*, 503 F. Supp. 2d at 1350

[15] *See also In re Openwave Sys., Inc.*, No. C 06-03468 SI, 2008 WL 410259, *4 (N.D. Cal. Feb. 12, 2008) (citing this Court's Order; dismissing plaintiffs' putative derivative action for the second time).

contrived metric to the annual returns experienced by shareholders, a completely different metric that actually accounts for the normal "ups and downs" in a company's stock performance.[16]

Plaintiffs' apples-to-oranges comparison is rendered even less informative by the substantial volatility in F5's stock price — assuming that *any* 20-day period should somehow reflect or follow an annualized trend defies both logic and common sense. *See PMC-Sierra*, 2007 WL 2427980 at *4 (in light of high stock price volatility, it is "perhaps not surprising that plaintiffs were able to identify numerous grants where the stock price was dramatically higher 20 days later, [but] there is nothing magical about the number 20 that gives rise to a strong inference of likely backdating"). Moreover, Plaintiffs fail to place the F5 percentage returns into the broader market context, making the analysis even less reliable. *See Openwave*, 503 F. Supp. 2d at 1351 ("Here, the Complaint presents the 20-day cumulative returns for each of the 21 questionable option grants, but does not compare them to any benchmarks. ... Instead, plaintiffs simply compare the 20 day return on the 21 particular, handpicked options grants to the average Openwave stock performance"); *Finisar*, 2008 WL 131867 at *10 (no "statistical analysis of the returns on the option grants compared to market returns").[17]

4. <u>F5 Did Not "Admit" Engaging In Illegal "Backdating."</u>

In addition to their flawed statistics-based theories, discussed above, Plaintiffs continue to insist that F5 "admitted" engaging in "backdating," because F5 publicly announced a financial restatement. Opposition at 12. Again, F5's restatement was in no way an admission that

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[16] In the Motion, F5 challenged Plaintiffs to explain how they went about "annualizing" the 20-day percentage returns on F5's option grants. In response, Plaintiffs claim that, "to state the obvious," they "multiplied the 20-day returns in order to determine what the annual or full-year return would be." Opposition at 14 n.11. But Plaintiffs conspicuously fail to identify what the 20-day returns were multiplied *by*, and the most logical multiplier — *i.e.*, 18.25, the number of 20-day periods in a 365-day year — does not yield the "annualized" return numbers Plaintiffs rely upon. Nothing about Plaintiffs' statistical "analysis" is obvious, and Plaintiffs persistently avoid explaining their methodology.

[17] Plaintiffs' reliance on 20-day percentage returns is also grounded in the fundamental assumption that, if companies have not "systematically taken advantage of their ability to backdate options within the 20-day windows," then there should be no appreciable difference between 20-day returns and annual returns. But the Merrill Lynch study (on which Plaintiffs' entire case depends) found that fundamental assumption *not* to be true. To the contrary, Merrill Lynch discovered that nearly *all* of the companies it investigated — not just those companies Merrill Lynch concluded were "at risk" of having engaged in "backdating" — "consistently generated excess returns [over the annual return] during the 20 day period following options grants." *See* Merrill Lynch Report (Supplemental Declaration of Brian D. Buckley ("Supp. Buckley Dec."), Ex. A) at 2. In short, the 20-day-percentage-returns metric is truly meaningless.

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"backdating" (or any wrongdoing whatsoever) occurred at F5 — in fact, F5's Special Committee concluded exactly the opposite. *See* Note 5, *supra*; *see also PMC-Sierra*, 2007 WL 2427980 at *5 ("Thus, the fact that PMC has admitted it erroneously recorded some option grant dates does not create an inference that the challenged options were intentionally and fraudulently backdated").

Plaintiffs also erroneously claim that F5 failed to explain how the unreliable measurement dates for certain of its option grants "did not result from backdating." Opposition at 12:26 (citation omitted). Not true. F5 specifically disclosed the reasons it concluded that certain measurement dates should not be relied upon. *See* Note 5, *supra*. *See also In re MIPS Tech., Inc. Deriv. Litig.*, No. C-06-06699 RMW, 2008 WL 131915, *9 (N.D. Cal. Jan. 11, 2008) (dismissing derivative suit despite admission of "backdating"; company's "public filings plausibly explain the source of those grants and why they were not backdated"). And Plaintiffs claim that F5 "did nothing to remedy those past errors." Opposition at 12:26 (citation omitted). Also not true. F5 publicly disclosed the extensive remedial measures it took in response to its internal investigation. *See* November 8, 2006 F5 Press Release (Supp. Buckley Dec. Ex. B); see also Verisign, 2007 WL 2705221 at *17.[18]

C. <u>None Of The F5 Grants Raises Any Inference Of Backdating.</u>

1. <u>Plaintiffs' Illustrative Grants (July 24, 2000) Were Not "Backdated."</u>

Plaintiffs argue that the July 24, 2000 grants to defendant McAdam, "plucked from the list of extraordinarily fortuitous grants at F5, demonstrates the strength with which plaintiffs have alleged facts that support a strong inference of defendants' backdating scheme." Opposition at 15:7-9. In fact, Plaintiffs' convoluted discussion of the July 24, 2000 grants, which Plaintiffs hold up as illustrative of "backdating," actually betrays the fatal flaws in Plaintiffs' overall methodology.

On July 19, 2000, F5 issued a press release announcing the hiring of John McAdam as F5's new President and CEO — the press release specifically disclosed that McAdam's start-date would

[18] Plaintiffs also claim, without citation, that, "[n]ot coincidentally, all of the errors in the measurement date of defendants' grants were to defendants' significant advantage." Opposition at 6 n.6 (citing *Middlesex Ret. Sys. v. Quest Software, Inc.*, — F. Supp. 2d —, No. CV 06-6863 DOC (RNBX), 2007 WL 3286784 (C.D. Cal. Oct. 22, 2007)). There is absolutely no evidence in the record to support that baseless statement. In addition, the *Middlesex* case (on which Plaintiffs rely throughout their Opposition) is wholly inapposite because *Middlesex* was a putative class action case, *not* a derivative case, and the Court did not even purport to address demand-futility concepts.

be *July 24, 2000*. Supp. Buckley Dec. Ex. C; Opposition at 15:11-12. In connection with his hiring, McAdam received two option grants, one grant for 645,000 options priced at $42.56 (F5's stock price on July 24, 2000) and one grant for 50,000 options priced at $1.00. AC ¶ 78. McAdam disclosed the first grant (via Form 3) on August 2, 2000, and the second grant (via Form 4) on October 4, 2000. *Id.* (These grants occurred in the pre-Sarbanes Oxley era, when option grant recipients were afforded a longer reporting period.)

Plaintiffs make much of the fact that the July 24, 2000 stock price "was the ***lowest*** closing price for the month of July." Opposition at 17:10. But Plaintiffs completely disregard the pivotal fact: the July 24, 2000 measurement date was ***disclosed in advance*** to the public. It is impossible for that date to have been chosen retroactively. *See, e.g., Finisar*, 2008 WL 131867 at *7 ("That August 31, 2005 was the date [defendants] joined the board supports a conclusion that that date was the proper measurement date for their grant and weighs against an inference of backdating absent particularly pleaded facts showing that the grant date is not the proper measurement date. Moreover ... ***there is an inference that backdating did not occur because the August 31, 2005 grant date was announced in advance***") (emphasis added); *CNET*, 483 F. Supp. 2d at 959 ("This grant, however, was tied to an event at the company and was not selected randomly"). Moreover, it is reasonable and logical to assume that F5's stock price — which had been volatile and had just experienced a steep drop in value (*see* AC ¶ 79) — climbed immediately following July 24, 2000 specifically *because* F5 had a new, accomplished CEO on board, and the market was trading on the strength of that event. But when F5 ***pre-disclosed*** July 24, 2000 as McAdam's start date, the Company could not possibly have known that the stock price on that date would be at a monthly low.

With regard to the grant of 50,000 options, it makes no sense to refer to the price of those options as "backdated," because the grant was not priced at the July 24, 2000 stock price ($42.56). The grant was priced arbitrarily at $1.00. Note that, in discussing the July 24, 2000 grants to McAdam, Plaintiffs say ***nothing*** about those grants being priced below fair market value. That is because neither grant was issued pursuant to F5's normal Stock Option Plans (some of which

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required pricing at 100% of fair market value, some of which did not). The July 24, 2000 grants to McAdam were issued pursuant to their own stand-alone stock option plans. *See* 2000 Form 10-K (Goodman Dec. Ex. A) ("In July 2000, the Company's Board of Directors adopted two nonqualified stock option plans (the 'McAdam Plans') in connection with hiring John McAdam …").[19] Importantly, ***neither of the McAdam Plans required the options to be priced at fair market value***. *See* Supp. Buckley Dec. Exs. D and E.[20]

Because the July 24, 2000 grants were issued pursuant to stand-alone stock option plans, those grants do not implicate ***any*** of Plaintiffs' theories regarding F5 allegedly having violated the fair-market-value requirements of the Company's Stock Plans (or allegedly contradicting public statements regarding its options granting practices). As the Court has recognized, "there is nothing per se impermissible with 'in the money options'" (Order at 11:22) — the only issue, therefore, is whether the July 24, 2000 grants were properly disclosed and accounted for. As discussed above, there can be no legitimate dispute that the grants were properly disclosed. And Plaintiffs do not even allege, let alone support with particularized facts, that the July 24, 2000 grants to McAdam were not properly accounted for, or that those grants were among the grants underlying F5's restatement.

[19] True to form, Plaintiffs attach nefarious intent to the fact that the McAdam Plans were not disclosed until F5 filed its 2000 Form 10-K on December 13, 2000. Opposition at 16. But Regulation S-K, Item 601 provides that copies of material contracts should be attached to the Form 10-Q or 10-K for the period in which the contracts were ***executed***. *See* 17 C.F.R. § 229.601(a)(4). F5's fiscal year ends in September, so the McAdam Plans were executed in the fourth quarter (July) of F5's fiscal year 2000. No Form 10-Q is filed in the fourth quarter, so the McAdam Plans were properly disclosed with F5's 2000 Form 10-K. Plaintiffs also assign fraudulent motives to the alleged fact that the specific prices of the July 24, 2000 grants were not "revealed" until January 24, 2001 (when F5 filed its amended 2000 Form 10-K/A). Opposition at 16:16. But the prices of McAdam's options were expressly disclosed in the terms of the McAdam Plans. More to the point, when those prices were specifically disclosed is utterly irrelevant because, as discussed above, the prices cannot have been "backdated." Finally, Plaintiffs state that the McAdam plans, "although undated, state that they were 'entered into *as of* July 24, 2000.'" Opposition at 16:6-7. But Plaintiffs offer no evidence — only their own self-serving skepticism — that F5 did not, in fact, adopt the McAdam Plans as of McAdam's ***pre-disclosed*** start date. *Finisar*, 2008 WL 131867 at *7 ("That August 31, 2005 was the date [defendants] joined the board supports a conclusion that that date was the proper measurement date for their grant and weighs against an inference of backdating …").

[20] Plaintiffs also attempt to dismiss the fact that the July 24, 2000 grants to McAdam were subject to vesting requirements by arguing that "regardless of when the options vested, the Company was harmed because the accounting treatment for in-the-money grants applies immediately." Opposition at 16 n.15. But, again, Plaintiffs fundamentally mischaracterize the issue before the Court: the issue is *not* whether improper accounting of stock options may cause "harm" to a company (in the form of a financial restatement); the issue is whether there is particularized evidence that the company's management intentionally chose incorrect grant measurement dates. Given that the only conceivable motive for engaging in such fraudulent conduct is to enrich the grant recipients, the fact that options are subject to extended vesting requirements makes enrichment inherently uncertain and, therefore, undercuts an inference of intent.

See PMC-Sierra, 2007 WL 2427980 at *5 ("Furthermore, plaintiffs have drawn no nexus between the option grants they are challenging in this action and PMC's 'admission' [*i.e.*, restatement] – plaintiffs do not appear to be contending that these grants are necessarily the ones with which the internal investigation found fault").

Finally, the July 24, 2000 grants also vividly illustrate Plaintiffs' inability to plead with particularity which Director Defendants allegedly approved which of the challenged option grants. Plaintiffs state, without citation or support, that "Defendants Higginson, Guelich and Grinstein were on the Compensation Committee responsible for making [the July 24, 2000] grant[s] to McAdam." Opposition at 15 n.13. But F5's 2000 Form 10-K states that "the Company's Board of Directors" adopted the McAdam Plans. Opposition at 16:10. And the McAdam Plans themselves were signed <u>only</u> by then-Chairman Jeffrey Hussey, who is ***not*** one of the Director Defendants who matter for demand-futility purposes. *See* Supp. Buckley Dec. Exs. D and E. In short, Plaintiffs cannot link the F5 Director Defendants to approval of the challenged grants, because there is no evidence any of those Directors "chose the date on which allegedly backdated options were to be granted." *See* Order at 21:2. Thus, for all the dust Plaintiffs kick up regarding the July 24, 2000 grants, there is absolutely ***nothing*** to suggest improper conduct in connection with those grants.

2. <u>The Three "Key" Grants Were Not "Backdated."</u>

Consistent with the Court's methodology in the Order, there are only three "key" grants in which at least three of the relevant Director Defendants received options: January 1, 2001; April 20, 2001; and May 6, 2002. There is no inference to be drawn that those grants were "backdated."

a. <u>January 1, 2001 Grant</u>

It is apparent from Plaintiffs' confusing response that they did not understand F5's analysis of the January 1, 2001 grant. *See* Motion at 18-21. Plaintiffs claim that the ***only*** explanation for the January 1, 2001 grant coinciding with the lowest monthly stock price is intentional "backdating." As an initial matter, the odds are 1 in 22 that result occurred purely by chance. More to the point, in its Motion, F5 set forth an alternative scenario that would have resulted in F5 innocently and

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appropriately choosing the lowest monthly price as the grant date. The SEC has recognized that a company may properly price an option grant pursuant to a ***formula***. *See* September 19, 2006 Guidance Letter from SEC Chief Accountant ("SEC Guidance Letter") at 7 (Buckley Dec. Ex. O).[21] The SEC described, as an example, a formula by which the option grant price is the lowest stock price during a 30-day period. *Id.* Another example would be a formula by which the grant price is the lower of the stock prices on two specific dates (such as the first day and the last day of the month). The point is, according to the SEC, it is not improper "backdating" to adopt a non-discretionary formula whereby the exercise price of an option is chosen ***after the stock's actual performance is known***. That approach merely requires the company to employ variable accounting until the grant measurement date is fixed. *Id.*

With regard to F5's January 1, 2001 grant, the most plausible, reasonable, and logical scenario is this: As disclosed in F5's public filings, the Company adopted a ***non-discretionary*** plan to grant options to non-employee directors in January of each year. *See* Motion at 18. Prior to January 2001, the Company also adopted a ***non-discretionary*** formula, pursuant to which the grant date for the January 2001 grant would be the lower of the stock price on January 1 or January 31.[22] F5's stock price rose during January 2001. *See* Opposition at 22:1-2. Therefore, pursuant to the non-discretionary formula, the January 2001 option grant ***had*** to be priced as of January 1, 2001. That day, however, was not a trading day; consequently, the market price of F5's stock on January 1 defaulted to the last trading day, December 28, 2000, when F5's stock price was $9.50. *See CNET*, 483 F. Supp. 2d at 960 ("Mere reliance on the numbers is not sufficient when plaintiffs are confronted with a legitimate, judicially-noticeable explanation for the grant date").

[21] Plaintiffs note for the Court that the SEC Guidance Letter was issued "almost seven years after" F5's January 1, 2001 option grant and the Letter "does not even mention this grant." Opposition at 20 n.19. F5 would have thought it obvious that the SEC Guidance Letter was issued to provide general guidance on options dating practices (indeed, even a cursory review of the Letter itself makes that clear). F5 has never suggested that the Letter was issued to F5, or issued specifically to address the January 1, 2001 grant.

[22] Plaintiffs inappropriately argue that "[i]f there was a formula, defendants would certainly know that it existed and would say so." Opposition at 20:9-10. F5 has only introduced facts referenced in the Amended Complaint or of which the Court can take judicial notice. Plaintiffs clearly know that if the January 1, 2001 grant was, in fact, issued pursuant to a formula, exactly as set forth above, F5 would be precluded from informing the Court of that fact in this context.

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If the January 1, 2001 grant was, in fact, issued pursuant to a non-discretionary formula, then the *only* issue is whether F5 properly applied variable accounting to the grant until the measurement date was set. SEC Guidance Letter at 7.[23] Plaintiffs do not even allege that F5 failed to properly account for the January 1, 2001 grant. Indeed, it is impossible for Plaintiffs to establish any nexus between the January 1 grant and F5's restatement of its financials. *PMC-Sierra*, 2007 WL 2427980 at *5. (It is worth noting, however, that when F5 publicly disclosed the reasons for its restatement, F5 did *not* disclose any accounting issues involving non-discretionary pricing formulas; the only evidence before the Court suggests, therefore, that the January 1 grant was properly accounted for.) Moreover, even if F5 erred in its variable accounting, that would simply reflect "sloppy accounting practices not rising to the level of fraud." *CNET*, 483 F. Supp. 2d at 955. Plaintiffs have raised no inference that the January 1, 2001 grant was "backdated."

b. **April 20, 2001 Grant**

Plaintiffs continue to defend their position that the April 20, 2001 grant was "backdated." This grant demonstrates that Plaintiffs' "backdating" accusations are not based on any cohesive, or even logical, methodology. Under Plaintiffs' theory, *any* grant that precedes an appreciable rise in stock price was, automatically and by definition, the product of fraud. The Court should reject Plaintiffs' challenge of the April 20, 2001 grant on the basis alone that it clearly proves too much.

Plaintiffs also half-heartedly contest that the April 20, 2001 grant was the product of F5's nondiscretionary plan to grant options to non-employee directors on the date of F5's Annual Meeting. But all of the publicly disclosed evidence compels exactly that conclusion. *See* Motion at 21-22. Given that the date of F5's 2001 Annual Meeting (April 20, 2001) was disclosed in advance,

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[23] Plaintiffs argue that even if the January 1, 2001 grant was issued pursuant to a non-discretionary formula, it would still have violated the 1998 Stock Plan's requirement that options be priced at not less than 50% of fair market value on the grant date. Opposition at 19-20. But Plaintiffs fundamentally misapprehend how the pricing formula operates. Under a formula, like the one discussed above, the grant date is the date ultimately determined by the formula. Consequently, by definition, the options are priced at fair market value on the grant date (once that date is set). Even if that were not the case, F5's stock price on January 31, 2001 was $17.00 and the grant price was $9.50, which is not less than 50% of $17.00. Therefore, even under Plaintiffs' flawed conception of the issue, the January 1, 2001 grant would not have violated the 1998 Stock Plan.

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it is simply not plausible to suggest that F5 retroactively chose that date to price options (especially because it was not a particularly favorable date). *MIPS*, 2008 WL 131915 at *9; *Finisar*, 2008 WL 131867 at *7. The April 20, 2001 grant was not "backdated."

c. **May 6, 2002 Grant**

The Court already rejected Plaintiffs' position that the May 6, 2002 grant was "backdated," Order at 15-16, and Plaintiffs have offered no new facts or arguments to save it from extinction. Plaintiffs' ***only*** basis for labeling the May 2002 grant as "backdated" is that it was priced at $11.12, the lowest closing price of the month for F5's stock. As the Court noted, the odds of that occurring by chance are an uncontroversial 1 in 22. Order at 16:17-18. (The Court also noted that the return on the May 2002 grant was only a meager 7.2%. *Id.*) More importantly, the May 6, 2002 grant was issued under F5's 1998 Stock Plan, which allowed grants to be priced at no less than 50% of fair market value. Twenty days after the grant, F5's stock price was $11.93, and the stock price was $12.16 when the grant was first disclosed to the SEC (AC ¶ 86-87) — both of those prices are within 50% of the $11.12 grant price. Thus, even if Plaintiffs were correct that the May 2002 grant was priced at less than 100% of fair market value on the grant date (though Plaintiffs offer ***no*** facts to support that contention), the 1998 Stock Plan was not violated. *See* Order at 16.[24]

Plaintiffs also argue that Defendants may not "rewrite history to say that they granted on a ***different date***," Opposition at 24, because the grant date impacts the proper accounting to be applied. *Id.* at 24 n.25. But Plaintiffs offer ***no*** facts, particularized or otherwise, to suggest that the grant was not, in fact, made on May 6, 2002. Moreover, Plaintiffs do not allege in the Amended Complaint, and certainly cannot establish, that the May 2002 grant was not properly accounted for. Plaintiffs ***imply*** that the grant contributed to F5's restatement (*id.*), but plead ***no*** nexus between the two events. *PMC-Sierra*, 2007 WL 2427980 at *5. The May 6, 2002 grant was not "backdated."

[24] Plaintiffs attempt to salvage their argument by claiming that F5 specifically represented that the May 2002 grant was priced at 100% of fair market value. Opposition at 24. That is patently false. Neither of the Proxy Statements that disclosed the May 2002 grant represented that the grant was made at 100% of fair market value. *See* Motion at 23. And the fact that the grant was priced at the May 6, 2002 stock price cannot be construed as an affirmative representation that the chosen price was 100% of fair market value on the grant date.

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3. The Remaining Five Grants Were Not "Backdated."

In its Order, the Court correctly ruled that Plaintiffs have not adequately pled any Director Defendant's involvement in, or awareness of, "backdating." Order at 20:25-21:1-9. And, as the Court recognized, it is axiomatic that mere approval of option grants or the threat of personal liability is inadequate to establish demand futility. Order at 20-21. In light of those rulings, it is not necessary for the Court to analyze the remaining grants in which fewer than three of the relevant Director Defendants received options, because there is no basis on which the requisite number of Directors could be interested in those grants. Nevertheless, Plaintiffs have still failed to plead any inference that the remaining non-"key" grants were "backdated."

a. October 1, 1999 Grant

Plaintiffs do not deny the fact that they lack standing to derivatively challenge the October 1, 1999 grant to Amdahl (not a relevant Director Defendant) because none of the Plaintiffs were F5 shareholders in October 2000. *See* RCW 23B.07.400(1). And contrary to Plaintiffs' assertion, Defendants do not "implicitly admit" this grant was "backdated." Opposition at 30:18. Plaintiffs' only bases for challenging this grant are that it was issued at the second-lowest monthly stock price and that F5's stock price rose following the grant.[25] As discussed above, Plaintiffs' metrics prove nothing, and the Court has already rejected that methodology for alleging "backdating."

b. April 27, 2001 Grant

Plaintiffs continue to challenge the April 27, 2001 grant to McAdam, despite the fact that the grant was priced at the ***thirteenth***-lowest closing price for the month. Plaintiffs' assumption that this grant was "backdated" is based purely on the fact that F5's stock price rose following the grant. As discussed above, that theory would mean that every grant with positive post-grant percentage returns was, by definition, fraudulently "backdated." That position is untenable. Moreover, had F5 really intended to "backdate" this grant, it could have chosen from multiple more advantageous dates in the same time-frame. *See* Order at 15; chart at AC ¶ 84.

[25] It is also important to recall that the October 1, 1999 grant occurred shortly after F5's June 4, 1999 IPO, in a period when F5's stock price soared from $14.87 to $114.00, so the rise in stock price after the grant is not surprising.

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c. <u>February 10, 2000; May 8, 2003; April 30, 2004 Grants</u>

Plaintiffs' only bases for challenging the February 10, 2000; May 8, 2003; and April 30, 2004 grants is that those grants were priced at the lowest, second-lowest, and lowest monthly closing prices, respectively. Plaintiffs refer to the "long odds" of an exercise price coinciding with a monthly low (*see, e.g.*, Opposition at 26:11; 27:11), but the odds are not "long" at all. As discussed in the Motion and above, Plaintiffs' generalized statistical theories do not support any inference of "backdating"; therefore, as the Court concluded, each grant must be analyzed independently. The odds of randomly pricing options at a monthly low are 1 in 22, and the Court has already ruled that ***"this alone is not sufficient to show with particularity that the option was backdated."*** Order at 16:15-17. The Amended Complaint contains not one new fact regarding any of these challenged grants that would compel the Court to reverse its prior rulings.

D. **<u>Plaintiffs' Generalized "Business Judgment" Allegations Remain Inadequate.</u>**

The Court previously rejected Plaintiffs' general allegations that the Director Defendants are interested, or failed to exercise valid business judgment, because the Directors allegedly approved "backdated" options or signed allegedly false financial statements. *See* Motion at 27-28. And as F5 has analyzed, the Amended Complaint did nothing to substantively bolster those allegations. *Id.* Plaintiffs' Opposition highlights that reality because Plaintiffs do not discuss a single new fact regarding the role any Director Defendant played in alleged "backdating."[26] Instead, Plaintiffs complain that, "[a]t the pleading stage, without access to the minutes of F5's Board and Compensation Meetings, defendants' calendars and e-mail correspondence, plaintiffs are absolutely incapable of pleading" particularized facts to support their demand-futility arguments. Opposition at 29:21-23. Apparently, under Plaintiffs' approach, a putative derivative plaintiff should always be granted full discovery ***before*** the plaintiff is required to plead demand futility. Like all of Plaintiffs' theories, that argument turns the derivative process completely on its head.

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[26] Plaintiffs also renew their argument that the F5 option grants were *ultra vires*. Opposition at 34-35. The Court rejected that argument because it assumes "backdating" occurred, which Plaintiffs have not shown. Order at 22 n.11.

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II. CONCLUSION

In *MIPS*, the Court dismissed a putative derivative action filed by the same counsel representing Plaintiffs here and based on virtually identical theories. The Court noted that the "sensitive [demand futility] inquiry is not amenable to 'boilerplate' pleading" and that "demand excuse requires particularized facts, not stray inferences." 2008 WL 131915 at *7-8. The *Finisar* Court rejected the same sort of "boilerplate" complaint filed by the same counsel, noting that "the burden rests on plaintiffs to demonstrate demand is futile based on particularize factual allegations, not by speculation." 2008 WL 131867 at *11. And the *Openwave* Court has now ***twice*** dismissed the same speculative arguments asserted by Plaintiffs' counsel (relying, in part, on this Court's Order). 2008 WL 410259. In short, Plaintiffs' flawed theories and methodologies have been repeatedly rejected by the courts, including this Court. Because the Amended Complaint adds nothing to fix those theories, the Amended Complaint should be dismissed with prejudice.

RESPECTFULLY SUBMITTED this 19th day of February, 2007.

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CERTIFICATE OF SERVICE

I hereby certify that on this 19th day of February, 2008, I caused the foregoing to be electronically filed with the Clerk of the Court using the CM/ECF System which will send notification of such filing to the following:

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